FILE COPY

Office Supreme Court, U.S.
FILED
JAN 10 1961
JAMES R. BROWNING, Clerk

No. 151

In the Supreme Court of the United States

OCTOBER TERM, 1960

JOHN T. JARECKI,
FORMER COLLECTOR OF INTERNAL REVENUE, ET AL.,
PETITIONERS

v.

G. D. SEARLE & CO.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR PETITIONERS

J. LEE RANKIN,
Solicitor General,
ABBOTT M. SELLERS,
Acting Assistant Attorney General,
HARRY MARSELLI,
NORMAN H. WOLFE,
Attorneys, Department of Justice,
Washington 25, D.C.

INDEX

	Page
Opinions below	1
Jurisdiction	1
Question presented	2
Statutes, Regulations, and Rulings involved	2
Statement	2
Introduction and summary	5
Argument:	
The taxpayer's income from sales of the drugs here involved could not constitute "abnormal income" within the meaning of Section 456(a)(2) of the Internal Revenue Code of 1939 and hence could not qualify for Korean War excess profits tax relief under Section 456	8
I. The terms of Section 456(a)(2), viewed in the light of the Korean War Excess Profits Tax Law as a whole and of the clearly expressed Congressional intent, establish that income from the sale of products (such as the drugs here involved) resulting from research and development is not entitled to relief as abnormal income from "exploration, discovery, or prospecting"	8
II. The legislative history establishes that, in including income resulting from "exploration, discovery, or prospecting" among the classes of "abnormal income" accorded special treatment under Section 456, Congress used those terms in the same sense in which they have been employed consistently in internal revenue taxation, including excess profits taxation, since 1918—*i.e.*, with reference only to the oil, gas, and other natural resources industries	18

579949—61——1

Argument—Continued

The taxpayer's income, etc.—Continued

II. The legislative history, etc.—Continued Page

A. During the World War I period, the excess profits tax provisions accorded special treatment to revenue from exploration, discovery or prospecting only with respect to mines, and oil and gas wells, granting entirely separate discretionary relief in other meritorious cases 19

1. The 1917 Acts 19

2. The Revenue Act of 1918 22

B. In the period between the two World Wars, the 1918 provisions for special treatment of income from exploration, discovery and prospecting were retained in the income tax laws through 1938, and applied only to the natural resources industries .. 32

1. Provisions for taxation of proceeds from the sale of discovered mining, oil, or gas properties 32

2. Provisions allowing depletion of oil, gas, and mining properties on the basis of discovery values 35

C. During the Second World War period, the 1939 Code contained separate provisions for relief, both for income tax and excess profits tax purposes, as to income from exploration, discovery and prospecting with reference only to the natural resources industries—and excess profits tax relief for other taxpayers was provided in other sections, utilizing other terminology 38

1. The general pattern of the Second World War Excess Profits Tax Law, and its relief provisions 38

Argument—Continued
The taxpayer's income, etc.—Continued
II. The legislative history, etc.—Continued
C. During Second World War, etc.—Con. Page
2. The terms "exploration, discovery and prospecting" were used to provide special treatment, as abnormal income, for income derived from the oil, gas and other natural resources industries. 50
D. During the Korean War period, the statute (Section 456) provided excess profits tax relief as to income resulting from exploration, discovery, or prospecting with reference only to the natural resources industries—and by separate sections provided relief with respect to income derived from new products, industrial expansion and other sources.. 55
1. The general pattern of the Korean war excess profits tax law and its relief provisions..... 55
2. In Section 456(a)(2)(B) of the Korean War excess profits tax law, relief for income from the sale of products of "research" and "development", allowed under the prior law, was deliberately omitted and relief was provided only for income from "exploration, discovery or prospecting" in the natural resources industries..... 65
Conclusion..... 75
Appendix..... 1a

CITATIONS

Cases: Page

Ambassador Hotel Co. of Los Angeles v. *Commissioner*, 280 F. 2d 303, petition for certiorari filed on October 26, 1960 56
Avey Drilling Machine Co. v. *Commissioner*, 16 T.C. 1281 48
Burford-Toothaker Tractor Co. v. *United States*, 262 F. 2d 891 59
Carpenter, L. E., & Co. v. *Commissioner*, 29 T.C. 562, review dismissed, 264 F. 2d 230 ..... 48, 67
Carpenter, L. E., & Co. v. *Commissioner*, 264 F. 2d 230 42
Cohan v. *Commissioner*, 39 F. 2d 540 48
Commissioner v. *Smith Paper*, 222 F. 2d 126 46
Crowell-Collier Publishing Co. v. *Commissioner*, 25 T.C. 1268, review dismissed, 259 F. 2d 860, certiorari denied, 358 U.S. 928 67
Crowell-Collier Pub. Co. v. *Commissioner*, 259 F. 2d 860, certiorari denied, 358 U.S. 928 46
Dayton Rubber Co. v. *Commissioner*, 249 F. 2d 2 45
Don Baxter, Inc. v. *Commissioner*, 29 T.C. 1027 ..... 46, 48
Dowd-Feder v. *Commissioner*, 173 F. 2d 673 45
Eitel-McCullough, Inc. v. *Commissioner*, 9 T.C. 1132 ..... 47, 48
Heiner v. *Diamond Alkali Co.*, 288 U.S. 502 23
Helms Bakeries v. *Commissioner*, 236 F. 2d 3 42
Helms Bakeries v. *Commissioner*, 263 F. 2d. 642, certiorari denied, 360 U.S. 903 42
Hewitt-Robins, Inc. v. *Commissioner*, 282 F. 2d 868 42
Keystone Brass Works v. *Commissioner*, 12 T.C. 618 ..... 47, 48
Keystone Macaroni Manufacturing Co. v. *Commissioner*, 18 T.C. 1078 48
Morgan Construction Co. v. *Commissioner*, 23 T.C. 242 48
Pantasote Leather Co. v. *Commissioner*, 12 T.C. 635 ..... 47, 48
Patent Button Co. of Tenn. v. *Commissioner*, 256 F. 2d 726 58
Pohatcong Hosiery Mills v. *Commissioner*, 162 F. 2d 146 41
Polaroid Corp. v. *Commissioner*, 278 F. 2d 148 ..... 14, 17, 19, 66, 68

Cases—Continued Page

Puget Sound Pulp & Timber Co. v. *Commissioner*, 277 F. 2d 803, certiorari denied, 364 U.S. 831 42

Ramsey Accessories Mfg. Corp. v. *Commissioner*, 10 T.C. 482 ..... 47, 48

Richey v. *Commissioner*, 19 T.C. 926 48

Rochester Button Co. v. *Commissioner*, 7 T.C. 529 ..... 47, 48

Southwestern Oil & Gas Co. v. *Commissioner*, 6 T.C. 1124 45

Specialties, Inc. v. *United States*, 174 F. Supp. 89 ..... 15, 66

Standard Hosiery Mills v. *Commissioner*, 249 F. 2d 469 58

United States v. *Cannelton Sewer Pipe Co.*, 364 U.S. 76 72

United States v. *Koppers Co.*, 348 U.S. 254 41

United States Rubber Co. v. *Commissioner*, 274 F. 2d 307, certiorari denied, 363 U.S. 827 ..... 42, 45

Welch v. *Obispo Oil Co.*, 301 U.S. 190 23

Williams Publications, E. W., Inc., v. *Commissioner*, 25 T.C. 282 48

Williamsport Co. v. *United States*, 277 U.S. 551 ..... 21, 23

Statutes:

Act of March 3, 1917, c. 159, 39 Stat. 1000:

Sec. 201 19

Sec. 203 20

Secs. 204–205 20

Sec. 206 20

Income Tax Act of 1913, c. 16, 38 Stat. 114, 116:

Sec. IIG 20

Internal Revenue Code of 1939:

Sec. 13(a) (26 U.S.C. 1952 ed., Sec. 13(a)) 39, 56

Sec. 23(ff) (26 U.S.C. 1952 ed., Sec. 23(ff)) 11, 71, 72

Sec. 105 (26 U.S.C. 1952 ed., Sec. 105) 11, 28, 34, 50, 51, 54, 71, 1a

Sec. 107(b) (26 U.S.C. 1952 ed., Sec. 107(b)) 71

Sec. 114(b) (26 U.S.C. 1952 ed., Sec. 114(b)) 12, 28, 32, 37, 50, 51, 54, 71, 1a

Sec. 272 (26 U.S.C. 1952 ed., Sec. 272) 41

Sec. 430 (26 U.S.C. 1952 ed., Sec. 430) 8, 2a

Sec. 430(a) (26 U.S.C. 1952 ed., Sec. 430(a)) 55, 61, 2a

Sec. 430(e) (26 U.S.C. 1952 ed., Sec. 430(e)) 3a

Sec. 430(f) (26 U.S.C. 1952 ed., Sec. 430(f)) 4a

Statutes—Continued

Internal Revenue Code of 1939—Continued

Page

Sec. 431 (26 U.S.C. 1952 ed., Sec. 431) 55, 5a
Sec. 432 (26 U.S.C. 1952 ed., Sec. 432) 56
Sec. 433 (26 U.S.C. 1952 ed., Sec. 433) 56, 5a
Sec. 433(a) (26 U.S.C. 1952 ed., Sec. 433(a)) .. 70, 71, 5a
Sec. 433(b) (26 U.S.C. 1952 ed., Sec. 433(b)) .. 32, 64, 7a
Sec. 434 (26 U.S.C. 1952 ed., Sec. 434) 56, 8a
Sec. 435 (26 U.S.C. 1952 ed., Sec. 435) 56, 8a
Sec. 435(b) (26 U.S.C. 1952 ed., Sec. 435(b)) 8a
Sec. 435(c) (26 U.S.C. 1952 ed., Sec. 435(c)) 9a
Sec. 435(d) (26 U.S.C. 1952 ed., Sec. 435(d)) 64
Sec. 435(e) (26 U.S.C. 1952 ed., Sec. 435(e)) 10, 13, 14, 61, 64, 65, 10a
Sec. 436 (26 U.S.C. 1952 ed., Sec. 436) 56
Sec. 441 (26 U.S.C. 1952 ed., Sec. 441) 56
Sec. 442 (26 U.S.C. 1952 ed., Sec. 442) 63, 13a
Sec. 442(a) (26 U.S.C. 1952 ed., Sec. 442(a)) ... 60, 13a
Sec. 442(c) (26 U.S.C. 1952 ed., Sec. 442(c)) 15a
Sec. 443 (26 U.S.C. 1952 ed., Sec. 443) 10, 61, 65
Sec. 443(a) (26 U.S.C. 1952 ed., Sec. 443(a)) 14a
Sec. 443(f) (26 U.S.C. 1952 ed., Sec. 443(f)) 10a
Sec. 444 (26 U.S.C. 1952 ed., Sec. 444) 10, 62, 63, 65, 17a
Sec. 444(f) (26 U.S.C. 1952 ed., Sec. 444(f)) 17a
Sec. 445 (26 U.S.C. 1952 ed., Sec. 445) 61, 63, 18a
Sec. 445(b) (26 U.S.C. 1952 ed., Sec. 445(b)) 18a
Sec. 446 (26 U.S.C. 1952 ed., Sec. 446) 61, 63, 18a
Sec. 447 (26 U.S.C. 1952 ed., Sec. 447) .. 59, 61, 63, 19a
Sec. 447(e) (26 U.S.C. 1952 ed., Sec. 447(e)) 63
Sec. 450 (26 U.S.C. 1952 ed., Sec. 450) 71, 21a
Sec. 453 (26 U.S.C. 1952 ed., Sec. 453) 70, 71, 21a
Sec. 456 (26 U.S.C. 1952 ed., Sec. 456) 2, 8, 10, 11, 13, 65, 68, 69, 73, 24a
Sec. 456(a) (26 U.S.C. 1952 ed., Sec. 456(a)) .... 2, 4, 5, 7, 8, 10, 13, 14, 15, 17, 28, 32, 57, 65, 67, 68, 72, 73, 24a.
Sec. 456(b) (26 U.S.C. 1952 ed., Sec. 456(b)) 25a
Sec. 710 (26 U.S.C. 1952 ed., Sec. 710) 12, 29a
Sec. 710(a) (26 U.S.C. 1952 ed., Sec. 710(a)) ... 38, 29a
Sec. 710(b) (26 U.S.C. 1952 ed., Sec. 710(b)) ... 38, 29a
Sec. 710(c) (26 U.S.C. 1952 ed., Sec. 710(c)) 38
Sec. 711 (26 U.S.C. 1952 ed., Sec. 711) 39

Statutes—Continued

Internal Revenue Code of 1939—Continued

Page

Sec. 711(a) (26 U.S.C. 1952 ed., Sec. 711(a)) ... 53, 30a
Sec. 711(b) (26 U.S.C. 1952 ed., Sec. 711(b)) ... 32, 39, 41, 53, 61, 31a
Sec. 712 (26 U.S.C. 1952 ed., Sec. 712) ... 32
Sec. 712(a) (26 U.S.C. 1952 ed., Sec. 712(a)) ... 39
Sec. 713 (26 U.S.C. 1952 ed., Sec. 713) ... 39, 42, 43, 44, 33a
Sec. 713(d) (26 U.S.C. 1952 ed., Sec. 713(d)) ... 43, 44, 34a
Sec. 713(e) (26 U.S.C. 1952 ed., Sec. 713(e)) ... 43, 44, 64, 35a
Sec. 713(f) (26 U.S.C. 1952 ed., Sec. 713(f)) ... 43, 44, 64, 35a
Sec. 714 (26 U.S.C. 1952 ed., Sec. 714) ... 39
Secs. 715–720 (26 U.S.C. 1952 ed., Secs. 715–720) ... 39
Sec. 720 (26 U.S.C. 1952 ed., Sec. 720) ... 39
Sec. 721 (26 U.S.C. 1952 ed., Sec. 721) ... 12, 13, 39, 40, 41, 45, 46, 47, 48, 49, 50, 57, 60, 65, 66, 67, 70, 37a.
Sec. 721(a) (26 U.S.C. 1952 ed., Sec. 721(a)) ... 10, 12, 13, 15, 16, 28, 32, 42, 46, 47, 48, 50, 51, 53, 54, 55, 57, 68, 37a.
Sec. 721(f) (26 U.S.C. 1952 ed., Sec. 721(f)) ... 46, 40a
Sec. 722 (26 U.S.C. 1952 ed., Sec. 722) ... 28, 39, 40, 41, 42, 43, 44, 45, 46, 47, 48, 49, 50, 57, 58, 59, 60.
Sec. 722(a) (26 U.S.C. 1952 ed., Sec. 722(a)) ... 40, 58, 41a
Sec. 722(b) (26 U.S.C. 1952 ed., Sec. 722(b)) ... 10, 46, 60, 61, 62, 41a
Sec. 722(d) (26 U.S.C. 1952 ed., Sec. 722(d)) ... 41, 43a
Sec. 722(f) (26 U.S.C. 1952 ed., Sec. 722(f)) ... 53, 44a
Sec. 728 (26 U.S.C. 1952 ed., Sec. 728) ... 55
Sec. 731 (26 U.S.C. 1952 ed., Sec. 731) ... 53
Sec. 732 (26 U.S.C. 1952 ed., Sec. 732) ... 44a
Sec. 732(a) (26 U.S.C. 1952 ed., Sec. 732(a)) ... 41
Sec. 732(b) (26 U.S.C. 1952 ed., Sec. 732(b)) ... 41
Sec. 732(c) (26 U.S.C. 1952 ed., Sec. 732(c)) ... 41, 57, 67

Statutes—Continued

Internal Revenue Code of 1939—Continued — Page

Sec. 732(d) (26 U.S.C. 1952 ed., Sec. 732(d)) — 42, 57
Sec. 735 (26 U.S.C. 1952 ed., Sec. 735) — 53
Sec. 736 (26 U.S.C. 1952 ed., Sec. 736) — 37a
Sec. 740 (26 U.S.C. 1952 ed., Sec. 740) — 51
Sec. 742 (26 U.S.C. 1952 ed., Sec. 742) — 45, 51

Revenue Act of 1916, c. 463, 39 Stat. 756, Sec. 5(a) — 20

Revenue Act of 1917, c. 63, 40 Stat. 300:
Sec. 201 — 20
Sec. 203 — 20
Sec. 203(d) — 20, 21
Sec. 204 — 21
Sec. 205 — 21
Sec. 205(a) — 21
Sec. 209 — 20
Sec. 210 — 21, 22
Sec. 212 — 21

Revenue Act of 1918, c. 18, 40 Stat. 1057:
Sec. 211(b) — 24, 25, 27, 28, 32, 54
Sec. 214(a) — 29, 31, 35, 55
Sec. 234(a) — 29, 30, 31, 35, 55
Sec. 301(a) — 22
Sec. 301(b) — 22
Sec. 302 — 22
Sec. 311(a) — 22
Sec. 311(b) — 22
Sec. 311(c) — 22
Sec. 312 — 22
Sec. 320(a) — 22
Sec. 325(a) — 24
Sec. 326(a) — 24
Sec. 327 — 22, 23, 28
Sec. 328 — 22, 23, 28
Sec. 336 — 22
Sec. 337 — 24, 25, 27, 28, 32, 50, 54

Revenue Act of 1921, c. 136, 42 Stat. 227:
Sec. 211(b) — 32
Sec. 337 — 32, 50

Revenue Act of 1924, c. 234, 43 Stat. 253:
Sec. 204(c) — 36
Sec. 211(b) — 33

Statutes—Continued

Revenue Act of 1926, c. 27, 44 Stat. 9: Page
Sec. 204(c) 36, 37
Sec. 211(b) 33
Revenue Act of 1928, c. 852, 45 Stat. 791:
Sec. 102(a) 33
Sec. 114(b) 37
Revenue Act of 1932, c. 209, 47 Stat. 169:
Sec. 102(a) 33
Sec. 114(b) 37
Revenue Act of 1934, c. 277, 48 Stat. 680, Sec. 114 37
Revenue Act of 1936, c. 690, 49 Stat. 1648:
Sec. 105 33
Sec. 114 37
Revenue Act of 1938, c. 289, 52 Stat. 447:
Sec. 105 34
Sec. 114 37
Revenue Act of 1951, c. 521, 65 Stat. 452, Sec. 342(a) 11, 71
Miscellaneous:
Bulletin on Section 722, Treasury Department (November, 1944), pp. 50–52, 116–117, 154–156 ..... 45, 46, 48
67 Cong. Rec. 3018–3019 37
67 Cong. Rec. 3761–3763 37
86 Cong. Rec. 12174–12177, 12919 52
H. Conference Rep. No. 1037, 65th Cong., 3d Sess., pp. 47, 50, 70 (1939–1 Cum. Bull. (Part 2) 130, 134, 136, 150) 25, 30
H. Conference Rep. No. 486, 67th Cong., 1st Sess., p. 25 (1939–1 Cum. Bull. (Part 2) 206, 215) 36
H. Conference Rep. No. 356, 69th Cong., 1st Sess., pp. 31–32 (1939–1 Cum. Bull. (Part 2) 361, 362–363) 37
H. Conference Rep. No. 3002, 76th Cong., 3d Sess., pp. 50, 51 (1940–2 Cum. Bull. 548, 556) 51
H. Conference Rep. No. 2586, 77th Cong., 2d Sess., pp. 60–61 (1942–2 Cum. Bull. 701, 718) 44
H. Conference Rep. No. 3231, 81st Cong., 2d Sess., p. 21 (1951–1 Cum. Bull. 268, 274–275) 63
H. Rep. No. 767, 65th Cong., 2d Sess., pp. 19–20 (1939–1 Cum. Bull. (Part 2) 86, 99–100) 23
H. Rep. No. 704, 73d Cong., 2d Sess., p. 25 (1939–1 Cum. Bull. (Part 2) 554, 572) 33
H. Rep. No. 146, 77th Cong., 1st Sess., pp. 2, 3, 6–7, 14–15 (1941–1 Cum. Bull. 550–551, 553–554, 560–561) 41, 44, 49

Miscellaneous—Continued Page

H. Rep. No. 2333, 77th Cong., 2d Sess., pp. 24, 27, 149 (1942-2 Cum. Bull. 372, 393, 394-395, 482)... 42, 46, 54
H. Rep. No. 3142, 81st Cong., 2d Sess., pp. 4, 5, 13, 15-16, 15-25, 16-17, 18-19, 19-21, 23-24, 54-55 (1951-1 Cum. Bull. 187, 189, 190, 195, 197-198, 197-204, 199-201, 203, 225-226)..... 12, 15, 16, 17, 56, 58, 59, 60, 62, 63, 64, 65, 66, 67, 73
House Hearings, Excess Profits Tax Act of 1950, pp. 47, 164-192, 169-170, 170, 171-172..... 49, 70
House Hearings, Revenue Act of 1918, Part I, pp. 437-528, 497-498..... 26, 31
Joint Hearings on Excess Profits Taxation, August, 1940, pp. 100, 224-227, 285-286..... 52
10 Mertens, *Law of Federal Income Taxation* (Rev.), Sec. 59.38..... 67
Rev. Rul. 236, 1953-2 Cum. Bull. 236... 11, 37, 67, 70, 47a.
S. Rep. No. 617, 65th Cong., 3d Sess., pp. 6, 8, 14 (1939-1 Cum. Bull. (Part 2) 117, 120-121, 122, 126-127..... 23, 24, 30
S. Rep. No. 275, 67th Cong., 1st Sess., p. 15 (1939-1 Cum. Bull. (Part 2) 181, 191)..... 36
S. Rep. No. 52, 69th Cong., 1st Sess., pp. 17-18 (1939-1 Cum. Bull. (Part 2) 332, 345-346)..... 37
S. Rep. No. 558, 73d Cong., 2d Sess., p. 30 (1939-1 Cum. Bull. (Part 2) 586, 609)..... 33
S. Rep. No. 2156, 74th Cong., 2d Sess., p. 18 (1939-1 Cum. Bull. (Part 2) 678, 689)..... 33, 34
S. Rep. No. 75, 77th Cong., 1st Sess., pp. 3, 6-7, 15-16 (1941-1 Cum. Bull. 564, 565)..... 42, 44
S. Rep. No. 673, Part 1, 77th Cong., 1st Sess., pp. 13-14 (1941-2 Cum. Bull., 466, 477-478)..... 54
S. Rep. No. 1631, 77th Cong., 2d Sess., pp. 38-40, 45, 186-188, 191, 205, 206-207, 211 (1942-2 Cum. Bull. 504, 536-538, 541-542, 641-643, 644, 654, 655, 656, 658-659)..... 42, 43, 44, 54
S. Rep. No. 2679, 81st Cong., 2d Sess., pp. 4-5, 13, 14, 17-18, 17-29, 19, 21, 24-25, 26-28 (1951-1 Cum. Bull. 240, 241, 242-243, 249, 251-252, 251-259, 254, 256-257..... 12, 13, 16, 17, 56, 58, 59, 60, 62, 65, 66, 67, 73

Miscellaneous—Continued Page

Senate Hearings, Excess Profits Tax Act of 1950, pp. 715–728, 777–781 70
Senate Hearings, Revenue Act of 1918, pp. 356–393 .. 26, 27, 31
Senate Hearings on the Second Revenue Act of 1940, pp. 217–218, 285, 328–329, 373–374 52
"Summary of * * * 'The Excess Profits Tax Act of 1950' as agreed to by the Conferees," prepared by the Staff of the Joint Committee on Internal Revenue Taxation (1951), pp. 13–14 63
Treasury Regulations 33 (1914 ed.):
Arts. 137–138 20
Arts. 139–145 20
Art. 142 20
Treasury Regulations 33 (1918 ed.):
Art. 170 21
Art. 171 21
Art. 172 21
Art. 173 21
Art. 174 21
Treasury Regulations 41 (1918 ed.):
Art. 42 22
Art. 52 21
Art. 56 21
Art. 59 21
Treasury Regulations 45 (1920 ed.):
Art. 13 24
Art. 40, as amended 24
Art. 167 29
Arts. 201–226 29
Art. 971 24
Art. 972 24
Treasury Regulations 112:
Sec. 35.713–1 44
Sec. 35.721–7 46
Sec. 35.722–2(b)(1), as amended 45
Treasury Regulations 130:
Sec. 40.456–2 ..... 4, 18, 68, 69, 46a
Sec. 40.456–7 12
Webster's New International Dictionary, Unabridged (Second ed.), pp. 745, 898, 1988 14

In the Supreme Court of the United States

OCTOBER TERM, 1960

No. 151

JOHN T. JARECKI,
FORMER COLLECTOR OF INTERNAL REVENUE, ET AL.,
PETITIONERS

v.

G. D. SEARLE & CO.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR PETITIONERS

OPINIONS BELOW

The opinion of the District Court (R. 41–45) is not officially reported. The opinion of the Court of Appeals (R. 49–53) is reported at 274 F. 2d 129.

JURISDICTION

The judgment of the Court of Appeals was entered on January 27, 1960. (R. 54.) On April 22, 1960, by order of Mr. Justice Clark, the time within which to file a petition for a writ of certiorari was extended to and including June 25, 1960. (R. 56.) The petition was filed on June 16, 1960, and granted on October 10, 1960, 364 U.S. 812. (R. 57.) The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the income received by the taxpayer from the sale of certain patented drugs resulted from "discovery", within the meaning of Section 456(a)(2)(B) of the Internal Revenue Code of 1939, so as to qualify for Korean War excess profits tax relief as "abnormal income".

STATUTES, REGULATIONS AND RULINGS INVOLVED

Section 456 of the Internal Revenue Code of 1939 (Appendix, *infra*, pp. 24a–29a) and other pertinent statutory and regulatory provisions are set forth in the Appendix, *infra*, pp. 1a–24a, 29a–52a.

STATEMENT

This action was instituted by the taxpayer (R. 3–15) to recover excess profits taxes aggregating $3,638,238.82 (plus interest) alleged to have been erroneously and illegally assessed and collected by the petitioners for the years 1950, 1951 and 1952. The material facts, as set forth in the District Court's findings (R. 41–43) and in the opinion of the Court of Appeals (R. 50), may be summarized as follows:[1]

The taxpayer, a Delaware corporation with its principal place of business in Skokie, Illinois, is engaged in the business of manufacturing and marketing "ethical drugs". Prior to 1950, and over a period of more than twelve months, the taxpayer incurred expenditures which resulted in the preparation and

[1] These facts are undisputed, having been developed entirely by admissions in the pleadings (R. 3–18), by a stipulation of facts (R. 24–25), and by answers (R. 21, 22–23, 39, 40) to interrogatories (R. 19, 20) and to requests for admissions (R. 26–28, 29–38).

manufacture of two pharmaceuticals, with the trade names of "Banthine" and "Dramamine". During the taxable years involved, the taxpayer derived income from the sale of those two drugs. (R. 41–42.) [2]

Both Banthine and Dramamine were developed as a result of research activities conducted by the taxpayer prior to 1950.[3] (R. 42.) Both are chemical drug compounds, which were unknown prior to their being prepared by the taxpayer through experiments with various chemical formulae. (R. 42; see also R. 27, 39.) The taxpayer applied for a product patent on Dramamine in March 1940 (granted in February of 1950) and on Banthine in May 1952 (granted in November of 1953). (R. 42.) [4]

---

[2] That income—which is the subject of the present controversy—amounted to, for the years 1950, 1951 and 1952, respectively, $3,328,606, $9,347,180 and $8,348,212 as to Banthine, and $2,044,797, $2,484,406 and $3,324,933 as to Dramamine. (R. 21.)

[3] The nature of pharmaceutical research involved is described in some detail in Exhibit C (unprinted) to the Government's Request for Admissions. (R. 26.)

The extent of the taxpayer's research and development program is also shown by the record in considerable detail—including specific figures as to the amounts (obviously constantly increasing) of expenditures, personnel, and facilities devoted by the taxpayer to its research activities. (R. 22–23.) See also the Exhibits (unprinted) to the Government's Request for Admissions (R. 26)—particularly, Exhibit A, pp. 10–13, "Change in Products and Services Furnished;" Exhibit B, Prospectus (1950), p. 7, "Research;" Exhibit D, Annual Report (1950), pp. 14–15, "Expansion of Research Personnel and Equipment;" Exhibit E, Annual Report (1951), pp. 14–15, "New Personnel and Facilities of Research during 1951," p. 20, "1951 Developments in the Products of Searle Research.")

[4] The taxpayer had also been granted a product patent in 1941 on a drug called Pavatrine (R. 42), from the sale of which it derived income in amounts ranging from some five hundred dollars in 1942 to in excess of a million dollars in 1949 and in 1950

In this action, the taxpayer sought to recover excess profits taxes for the years in question, upon the theory that its income from the sales of Banthine and Dramamine during the period 1950 through 1952 constituted "abnormal income" within the meaning of Section 456(a)(2) of the Internal Revenue Code of 1939. (R. 41–43, 49–52.) Upon the Government's motion for summary judgment (R. 40–41), the District Court dismissed the complaint (R. 45). It held that the taxpayer's income from sales of Banthine and Dramamine was not income resulting from "exploration, discovery, or prospecting" within the meaning of Section 456(a)(2)(B), but income from the sale of products arising out of research and development. The District Court further held that the taxpayer's income from the sale of the drugs in question may not be classified as "abnormal" under the Regulations (Section 40.456–2(b) of Treasury Regulations 130) promulgated pursuant to the last sentence of Section 456(a)(2). (R. 44.)

The Court of Appeals held, however, that the income in question could qualify for relief as income from "discovery" under Section 456(a)(2)(B).[5] Accordingly, it reversed and remanded the case for trial, stating that a "genuine issue of material fact existed

(R. 21). The income from this drug is not involved in the present controversy.

The taxpayer had also applied for patents on two other drugs, Tetrathione and Hydryllin, which were denied (or abandoned) in 1948 and 1952, respectively (R. 42), but neither of those drugs is involved in this controversy.

[5] In view of its construction of Section 456(a)(2)(B), the Court of Appeals found it unnecessary to consider the District Court's interpretation of the applicable Regulations. (R. 53.)

as to whether Banthine and Dramamine were actually discoveries". (R. 53.)[6]

INTRODUCTION AND SUMMARY

The Korean War excess profits tax law, like its World War II predecessor, makes provisions in various ways for treating certain classes of income as "abnormal income." Such "abnormal income" is relieved from the full incidence of excess profits taxation by reallocation to other tax years. The statutory issue presented by this case is whether taxpayer's income from the sale of two of its drugs can qualify for relief under Section 456(a)(2)(B), which relates to income from "exploration, discovery, or prospecting."

Taxpayer's position is bottomed on the proposition that the word "discovery", in one of its dictionary meanings, is broad enough to cover either an invention or a new product which is the outgrowth of research and development. We do not deny that "discovery" is a word of various meanings, some of broad connotation. We point out, however, that in one of its most familiar usages it relates to the finding of natural resources. In our view, it is in this sense that the term is used in the statute.

For this view (which has been adopted by the First Circuit in the companion *Polaroid* case), Section 456(a)(2)(B) provides its own intrinsic evidence. "Discovery" does not appear in isolation.

[6] Subsequently, on April 22, 1960, the Government filed a motion with the Court of Appeals for leave to file a petition for rehearing out of time, for the purpose of presenting more extensive legislative history of the Code section here involved and its antecedents. That motion was denied on April 28, 1960. (R. 55.)

The statutory phrase is "exploration, discovery, or prospecting." Each of the three nouns employed relates to a distinct phase of activity in the natural resources industries. Since it is this relationship to natural resources which provides their common denominator, the interpretation which we urge is, on the face of it, the most plausible one. It is also the interpretation which has been adopted in Treasury Regulations.

There are other considerations which point most persuasively to the same conclusion.

There is, first, the consideration that other provisions in the Korean War law provide relief in appropriate cases in relation to new products, growth or expansion in commercial activity.

Even more pointedly, Congress rejected an earlier provision of the World War II law which had explicitly granted relief to income resulting from "research, or development of tangible property, patents, formulae, or processes," while concurrently retaining a provision authorizing relief in respect of income from the *sale* of patents, formulae or processes. The reason assigned for the elimination of the provision governing "research and development" income seems conclusive against the taxpayer's position; both the relevant Senate and House reports described the excised portion as "a potential loophole of major dimensions" and stated that there appeared to be "no means of restricting" such an adjustment to "truly meritorious cases" without delegating to administrative authorities a breadth of discretion which Congress regarded as undesirable. Congress was appar-

ently of the view that no comparable breadth of discretion was necessary in order to enable the Commissioner to identify income from specific mineral deposits or from patents, formulae or processes which already had been the subject of a sale.

A further factor which bears importantly upon the issue of statutory interpretation is that the words "exploration", "discovery" and "prospecting" have been used repeatedly in income and excess profits tax statutes since 1918 (*e.g.*, in connection with mineral depletion and sale of minerals property) and that they have been used without exception to refer to the natural resources industries, for which Congress has frequently provided—in various ways and for various reasons—special tax treatment. Indeed, it was those industries which sponsored Section 456(a)(2)(B).

Finally, a study of the successive excess profits tax statutes and of their evolution serves to emphasize that Congress had gradually turned from relief provisions which vest broad and virtually unfettered discretion in the Commissioner and has substituted provisions which, in its view, permit computations to be made with reasonable accuracy and certitude and in terms of settled tax concepts. To develop this point we have undertaken to explain at considerable length the operation of the various excess profits tax statutes (and, also, of related income tax provisions) beginning with the laws enacted during World War I. This history shows, we believe, that it would be inconsistent with the scheme of the law as it emerged during the Korean War to interpret Section 456 as covering income, of a manufacturer from sales of a

new product resulting from research or development. Such an interpretation, as earlier observed, would also run directly counter to the authoritative statements in Congressional reports explaining the reasons which prompted the Congress to abandon the earlier (World War II) provision broadly granting relief in relation to income from research and development.

ARGUMENT

THE TAXPAYER'S INCOME FROM SALES OF THE DRUGS HERE INVOLVED COULD NOT CONSTITUTE "ABNORMAL INCOME" WITHIN THE MEANING OF SECTION 456(a)(2) OF THE INTERNAL REVENUE CODE OF 1939 AND HENCE COULD NOT QUALIFY FOR KOREAN WAR EXCESS PROFITS TAX RELIEF UNDER SECTION 456

I. THE TERMS OF SECTION 456(a)(2), VIEWED IN THE LIGHT OF THE KOREAN WAR EXCESS PROFITS TAX LAW AS A WHOLE AND OF THE CLEARLY EXPRESSED CONGRESSIONAL INTENT, ESTABLISH THAT INCOME FROM THE SALE OF PRODUCTS (SUCH AS THE DRUGS HERE INVOLVED) RESULTING FROM RESEARCH AND DEVELOPMENT IS NOT ENTITLED TO RELIEF AS ABNORMAL INCOME FROM "EXPLORATION, DISCOVERY, OR PROSPECTING"

The sole issue in this case concerns the treatment to be accorded to the taxpayer's income from the sales of the drugs Banthine and Dramamine for the purposes of the so-called Korean War Excess Profits Tax Law (Subchapter D, which was added to Chapter 1 of the 1939 Code[1] by the Excess Profits Tax Act of 1950, c. 1199, 64 Stat. 1137, Sections 430, *et seq.* of the Code (Appendix, *infra*, pp. 2a–29a)). More specifically, the question is whether that income can

[1] All Code references herein are to the Internal Revenue Code of 1939.

qualify for excess profits tax relief under Section 456 (Appendix, *infra*, pp. 24a–29a).

The facts are not in dispute (R. 49–53). They establish (R. 41–43, 50) that the chemical drug compounds Banthine and Dramamine were developed from and arose out of research activities conducted by the taxpayer before 1950 (over a period of more than twelve months) and that they were not in existence prior to their preparation by the taxpayer through experiments with various chemical formulae. It is also undisputed that, in the years immediately following the commercial introduction of Dramamine in 1949 and of Banthine in 1950, the taxpayer derived substantial income (running into millions of dollars annually) from sales of those products (R. 13). For present purposes, we do not question the novelty and usefulness of the drugs in question or the scope and intensity of the research effort leading to their development.

The Korean War Excess Profits Tax Law taxed at high rates all corporate profits in excess of a certain norm or level, called the "excess profits credit", deemed to represent the taxpayer's "normal" profits. The credit was to be computed either upon the basis of the taxpayer's average earnings during a specified prior period (called the "base period", generally the years 1946 through 1949) or upon the basis of invested capital, whichever resulted in the lesser tax—except that the law contained numerous provisions dealing with special situations or granting "relief" for "hardship" cases.[8] The present case involves one

[8] A more detailed analysis of the statute appears *infra*, pp. 55–65.

of the provisions (Section 456) under which relief was provided with respect to "abnormal" income received during the taxable year—the relief granted being by way of a computation designed to alleviate the burden of the excess profits tax for the taxable year by permitting the reallocation of certain portions of the abnormal income from the years of its realization to the other years to which it was really attributable.

The taxpayer seeks to apply Section 456 to its income resulting from the sales of its new products. The Government urges, on the contrary, that the relief provisions of Section 456 cannot be applied to income resulting from the sale of tangible personal property reflecting new products, industrial expansion, or the like.[9]

In Section 456(a)(2), the term "abnormal income" is restricted to income of the following designated classes:

> (A) Income rising out of a claim, award, judgment, or decree, or interest on any of the foregoing; or
>
> (B) Income resulting from exploration, discovery, or prospecting, or any combination of

[9] As more fully shown, *infra*, pp. 61–65, the Korean War Excess Profits Tax Law contained other provisions—entirely separate and distinct from Section 456—specifically designed to accord some relief to corporations which, like the taxpayer, experienced unusual growth during and immediately after the statutory "base period" by reason of expansion, increased production capacity, or introduction of new products. See Sections 435(e), 443, and 444 (Appendix, *infra*, pp. 10a–13a, 14a–17a). Generally, under the World War II law such claims had been asserted under Section 721(a)2(C) and Section 722(b)(4).

the foregoing, extending over a period of more than 12 months; or

(C) Income from the sale of patents, formulae, or processes, or any combination of the foregoing, developed over a period of more than 12 months; or

(D) Income includible in gross income for the taxable year rather than for a different taxable year by reason of a change in the taxpayer's method of accounting.

Each of the designated classes, it should be noted, consists of a non-recurring type of income which is established or ascertainable without undue difficulty under settled concepts, and the mathematical or "automatic" relief formula of Section 456 is readily applicable to income falling within those classes.

Thus, the existence and the amount of a "claim, award, judgment, or decree" are readily ascertainable—generally, by the amount of the actual payment or by documents fixing the rights thereto. Similarly, income resulting from the sale of patents, formulae, or processes,[10] and income includible in gross income for a particular year by reason of a change in accounting methods can be readily determined. The same is generally true of income resulting from "exploration, discovery, or prospecting" of natural resources. (See Rev. Rul. 236, 1953–2 Cum. Bull. 236 (Appendix, *infra*, pp. 47a–52a); see, also, Sections 23 (ff),[11] 105, and

[10] In some situations the terms of a particular sale of a patent might provide for future royalty payments, but the sale itself would normally be a non-recurring event.

[11] Subsection (ff) was added to Section 23 by Section 342(a) of the Revenue Act of 1951, c. 521, 65 Stat. 452.

114(b) of the Code. The "discovery value" of natural resources is a well-established tax concept, and, under specific provisions of the Code and of the Regulations, it may be mathematically computed. See Treasury Regulations 130, Section 40.456–7.

In enacting the Korean War Excess Profits Tax Law, Congress recognized that the relief provisions of the Second World War Excess Profits Tax Law (Subchapter E, added to Chapter 2 of the 1939 Code by Section 201 of the Second Revenue Act of 1940, c. 757, 54 Stat. 974, Sections 710, *et seq.*, Appendix, *infra*, pp. 29a–46a) had caused extended delay in the settlement of claims and that the exercise of subjective judgments in administering the relief provisions of that law had given rise to numerous complaints. (See H. Rep. No. 3142, 81st Cong., 2d Sess., pp. 16–17 (1951–1 Cum. Bull. 187, 197–198); S. Rep. No. 2679, 81st Cong., 2d Sess., pp. 17–18 (1951–1 Cum. Bull. 240, 251–252).) Consequently, in the Korean War law Congress reduced to a minimum the amount of administrative discretion involved in the relief provisions and substituted an entirely different approach to the grant of relief—one broadly rested upon the application of prescribed mathematical formulae.

In Section 721 of the Code (Appendix, *infra*, pp. 37a–40a)—the World War II provision granting relief with respect to "abnormal" income received during the taxable year—the definition of "abnormal income" had included (section 721(a)(2)(C)) income resulting from "research, or development of tangible

property, patents, formulae, or processes".[12] In the Korean War law, in Section 456 (the counter-part to World War II Section 721), that classification was deliberately eliminated because Congress had concluded that "there appeared to be no means of restricting such an adjustment to truly meritorious cases other than by the introduction of a large degree of administrative discretion of the type required by the general relief clause of the World War II law * * * and because the need for a reallocation of such income seemed to be materially less than for the other classes of income described above". S. Rep. No. 2679, 81st Cong., 2d Sess., p. 14 (1951–1 Cum. Bull. 240, 249). Relief under Section 456(a)(2) was accordingly restricted to the four classifications noted above. Thus, both the Commissioner and the courts were relieved of the burden of determining what was an invention, formula or process resulting from research or development and what merely was a minor improvement, a mechanical change, etc.[13]

---

[12] The complete provision of Section 721(a)(2)(C) was as follows:

> (C) Income resulting from exploration, discovery, prospecting, research, or development of tangible property, patents, formulae, or processes, or any combination of the foregoing, extending over a period of more than 12 months, * * *.

[13] Note that in Section 435(e)(1)(B), one of the provisions granting favorable treatment to "growth" businesses, the problem of establishing whether a particular product was an invention, etc., was avoided by the statutory phraseology limiting relief to cases where—

> (ii) 40 percentum or more of the taxpayer's net sales for the calendar year 1950 is attributable to a product, or class of products * * * of a kind not generally avail-

In this setting, the court below was clearly in error in concluding (R. 52–53) that the taxpayer's income from the sale of the drugs in question during the taxable years can qualify as income from a "discovery" within Section 456(a)(2)(B). Its error is primarily the result of isolating the word "discovery" from its context in the statutory phrase "exploration, discovery, or prospecting" and interpreting it in accordance with what the court regarded as its dictionary meaning, *i.e.*, "Finding out or ascertaining something previously unknown or unrecognized; as Curie's *discovery* of radium". (R. 52.) However, the same authority (Webster's New International Dictionary, Unabridged (Second ed.), p. 745) defines "discovery" as an "Act, fact, process, or instance of discovering" and, in addition to the example selected by the Seventh Circuit as the "common accepted meaning", lists others drawn from the fields of geography, science, drama and law, among others, including: "5. *Mining.* The original finding of part of a vein or lode. It is a prime requisite in the valid location of a mining claim." At best, the dictionary definitions of the term "discovery" are inconclusive, since many different meanings are apparent. See the opinion of the First Circuit in *Polaroid Corp.* v. *Commissioner*, 278 F. 2d 148, 151–152, No. 169, this Term, reaching

---

able to the public at any time prior to January 1, 1946 * * *.

The amount of the relief provided for taxpayers qualifying under Section 435(e) also was set forth in terms of a mathematical formula.

a conclusion directly opposed to the Seventh Circuit's views."[14]

Since the word "discovery" in Section 456(a)(2)(B) appears between the words "exploration" and "prospecting", its meaning cannot be determined in isolation, especially since each of the three connected nouns has a "readily apparent common denominator" (278 F. 2d., at 152), *i.e.*, natural resources, or the natural resources industries.

The Seventh Circuit's analysis (R. 52–53) of a portion (p. 13) of H. Rep. No. 3142, *supra*—the only legislative material to which it refers—shows, we believe, that the court misunderstood what Congress was seeking to do in the Korean War law. The court below recognized (R. 52) that the elimination of relief for the "research" and "development" class of income (relief which had been granted in Section 721(a)(2)(C) of the World War II law) "served the Congressional objective" of plugging a loop-hole. However, it erroneously concluded (R. 52–53) that "the plugging of the loophole which existed under a former Act because of the use of the unqualified terms 'research' and 'development' does not require that the word 'discovery' which the Congress saw fit to re-employ in the latter enactment [Section 456] be regarded as having taken on the limited and qualified meaning the Government would ascribe to it."

We do not suggest that "discovery" has taken on any new meaning in the Korean war law, but, rather,

[14] A conclusion similar to that of the First Circuit was reached in *Specialties, Inc.* v. *United States*, 174 F. Supp. 89, 94 (E.D.N.Y.).

that it is used there in the same sense in which the term has been employed in the tax laws since 1918 (particularly when used in association with "exploration" and "prospecting"), namely, to refer to the natural resources industries. (See *infra*, pp. 18–55.) In both H. Rep. No. 3142, 81st Cong., 2d Sess., p. 13 (1951–1 Cum. Bull. 187, 195) and S. Rep. No. 2679, 81st Cong., 2d Sess., p. 19 (1951–1 Cum. Bull 240, 249), Congress made it plain that it proposed to eliminate the World War II provision which had granted relief to income "resulting *from the sale of tangible property* arising out of research and development" (emphasis supplied). It did so for these reasons: (1) that that "provision in the old law was a potential loophole of major dimensions";[15] (2) that there "seemed to be materially less" need for relief for income of that type; and (3) that there seemed to be "no means of restricting" such relief "to truly meritorious cases" other than by resorting to the "administrative discretion" method of relief prevalent under the World War II law.

In the absence of any acceptable alternative for the benefit of meritorious "research" and "development" cases, Congress decided to close the loop-hole by eliminating from the Korean War relief provisions those items requiring subjective or discretionary judgment for appropriate administration, namely, all income "resulting *from the sale* of tangible property arising out of research and development". Significantly, Congress retained a provision for relief in respect to one segment of the broader category con-

[15] This "potential loophole" is discussed further *infra*, pp. 66–67.

tained in Section 721(a)(2)(C) covering all income resulting from "research, or development of tangible property, patents, formulae, or processes". The limited retention of this one segment—income from the sale of "patents, formulae, or processes" *themselves* (Section 456(a)(2)(C))—can be explained only by the consideration that the income from the sale of patents, formulae, or processes is readily ascertainable—like the income of the other classes for which Congress determined to retain relief in the Korean War law. See *supra,* pp. 10–12; see, also, *Polaroid Corp.* v. *Commissioner, supra,* 278 F. 2d at 153.

Under the Seventh Circuit's interpretation, the meaning of "exploration, discovery, or prospecting"—characterized by the First Circuit in *Polaroid* (p. 154) as "well-recognized words of art" in the tax law—would be distorted, the potential loop-hole would be reopened, and the basic Congressional purpose of doing away with difficult discretionary judgments (H. Rep. No. 3142, *supra,* pp. 16–17; S. Rep. No. 2679, *supra,* pp. 17–18) would be thwarted. It may be noted, in this connection, that in remanding this case to the District Court, the Seventh Circuit did not suggest any criteria for determining which inventions, formulae, processes, etc. are "actually discoveries", *i.e.,* real inventions, and which are mere improvements or mechanical changes from existing knowledge. Nor has the court below indicated a method for determining how much of the taxpayer's income is due to the fact of invention and how much to manufacturing know-how or skills, sales promo-

tion, and similar elements of business success. The inevitable result of the Seventh Circuit's approach would be precisely what Congress explicitly intended to avoid in the Korean War law: it would plunge the courts into the same mass of technological, economic, accounting and statistical data employed for the administrative determination of excess profits tax relief under the unsatisfactory and deliberately abandoned scheme of the Second World War law.[18]

II. THE LEGISLATIVE HISTORY ESTABLISHES THAT, IN INCLUDING INCOME RESULTING FROM "EXPLORATION, DISCOVERY, OR PROSPECTING" AMONG THE CLASSES OF "ABNORMAL INCOME" ACCORDED SPECIAL TREATMENT UNDER SECTION 456, CONGRESS USED THOSE TERMS IN THE SAME SENSE IN WHICH THEY HAVE BEEN EMPLOYED CONSISTENTLY IN INTERNAL REVENUE TAXATION, INCLUDING EXCESS PROFITS TAXATION, SINCE 1918—*i.e.*, WITH REFERENCE ONLY TO THE OIL, GAS, AND OTHER NATURAL RESOURCES INDUSTRIES

The terminology of the provision under which the taxpayer seeks relief was not new to the Excess Profits Tax Act of 1950. The words "exploration, discovery, or prospecting" were employed in several provisions of the first comprehensive excess profits tax statute, the Revenue Act of 1918, c. 18, 40 Stat. 1057, in order to grant relief to the oil, gas, and mining industries. Since 1918, the same phrase, with occasional variations, has been used repeatedly

[18] Consistently with our view of the statute, Treasury Regulations 130, Section 40.456-2(b) (Appendix, *infra*, pp. 46a–47a) provides:

> Income from the sale of tangible property arising out of research and development which extended over a period of more than 12 months is not included in the list of abnormal types of income to which section 456 is applicable, and such income may not constitute a class of income for purposes of that section. * * *

in the several excess profits tax statutes and in other Revenue Acts, again with reference only to those natural resources industries. In the area of taxation, the terms have indeed become "well-recognized words of art." *Polaroid Corp.* v. *Commissioner*, *supra*, 278 F. 2d at 154. Neither the phrase "exploration, discovery, or prospecting", nor any of those individual words, has appeared in the tax statutes with reference to inventions, patented drugs, chemical formulae, or processes.

In the sections which follow, we undertake to describe the essential features of the various excess profits tax statutes which have been passed by the Congress during the two World Wars and during the Korean conflict, and to trace the lines of development. We do not confine ourselves to those provisions which bear directly upon the concept of abnormal income resulting from discovery, but seek also to provide information as to the scheme of the various statutes in order to sketch the general background against which the particular problem presented is to be viewed.

A. *During the World War I period, the excess profits tax provisions accorded special treatment to revenue from exploration, discovery or prospecting only with respect to mines and oil and gas wells, granting entirely separate discretionary relief in other meritorious cases*

1. The 1917 Acts

The Act of March 3, 1917, c. 159, 39 Stat. 1000, contained a very brief excess profits tax provision, imposing (Section 201) an additional tax upon the net income of corporations and partnerships in ex-

cess of a specific sum and of a certain percentage of "the actual capital invested". The computation of this tax was tied in with the income tax, including the special depletion provisions for taxpayers in the natural resources industries,[17] pursuant to Section 203. See also Sections 204, 205 and 206. This Act was in effect for only a few months and was replaced by the Revenue Act of 1917, c. 63, 40 Stat. 300, enacted October 3, 1917, Title II of which comprised a much more complete "War Excess Profits Tax".

The Revenue Act of 1917 imposed (Section 201) on every corporation, partnership or individual an additional tax upon net income in excess of "the deduction"—defined (Section 203) as a specific sum, plus a percentage of invested capital (dependent upon the pre-war rate of return on invested capital). Special provisions were made for relief, as to both "the deduction" and the invested capital, where the statutory criteria were inapplicable (Sections 203(d), 209, and

[17] The peculiar problems of the mining industry due to wasting assets were recognized in the initial income tax law (Income Tax Act of 1913, c. 16, 38 Stat. 114, 166, Section II G), which provided for "a reasonable allowance for depletion of ores and all other natural deposits". See Treasury Regulations 33 (1914 ed.), Arts. 139–145, implementing the statutory provisions concerning depletion in the natural resources industries and contrast Arts. 137–138, providing for the allowance for depreciation of patents on a cost basis prorated over a 17-year period.

Those problems were similarly recognized, with further limitations, in the Revenue Act of 1916, c. 463, 39 Stat. 756, Section 5(a).

The aggregate depletion deductions allowable under both the 1913 Act (see Treasury Regulations 33 (1914 ed.), Art. 142) and the 1916 Act were limited to the taxpayer's investment in the property (cost) or its 1913 value.

210), or the corporation was not in existence during the pre-war period (Section 204), or had little or no pre-war net income or an unusually low pre-war return on invested capital (Section 205(a)). It is notable that virtually from the beginning of excess profits taxation special relief has been provided for businesses whose earnings were unusually or abnormally low during the pre-war period, and that the grant of such relief depended upon non-reviewable administrative findings of the Secretary of the Treasury.[18] Sections 203(d), 205 and 210. See, also, *Williamsport Co.* v. *United States,* 277 U.S. 551. In the same 1917 Act, Congress recognized the indefinite and speculative value of patents, trade-marks, and copyrights by specifically limiting the values accorded such assets in the computation of invested capital for excess profits tax purposes. Section 207; see Regulations 41 (1918 ed.), Arts. 56 and 59.[19]

[18] The relief provisions of this early statute were liberally construed. See Treasury Regulations 41, promulgated under the Revenue Act of 1917, Art. 52.

[19] The excess profits tax provisions of the Revenue Act of 1917 were coordinated with the other internal revenue laws in effect at the time. Section 212. See fn. 17, *supra*, p. 20, with respect to the provisions of the Revenue Act of 1916 for depletion allowances in the cases of oil and gas wells and mines. Treasury Regulations 33 (1918 ed.), implementing the Revenue Act of 1916, *supra*, as amended by the Revenue Act of 1917, *supra*, contained detailed provisions for the computation of depletion allowances for oil and gas properties (Art. 170), mines or mineral properties (Arts. 171–172), or timber (Art. 173) on a basis of recovery of cost or fair market value as of March 1, 1913. In contrast, the Regulations with respect to the depreciation of patents provided (Art. 174): "In determining the amount deductible on

2. The Revenue Act of 1918

The Revenue Act of 1918, c. 18, 40 Stat. 1057, included as Title III a "War-Profits and Excess-Profits Tax". This Act, drafted after experience under the prior statutes, contains many concepts which have survived and have been incorporated in the most recent excess profits tax laws, including provision for the special treatment of the oil, gas and other natural resources industries.

The excess profits tax provisions of the Revenue Act of 1918 were again coordinated specifically with the income tax sections. Sections 320(a)(3) and 336. The tax, imposed only on corporations, applied to the years 1918 and 1919 and was computed by a rather complicated formula based primarily upon percentages of invested capital. Sections 301 (a) and (b); 302; 311(a); 312. Special methods of computation were authorized for corporations which were non-existent or had little or no net income during the pre-war period. Section 311 (b) and (c). Discretionary relief was provided under Sections 327 and 328 for hardship cases and situations where invested capital could not properly be determined.

Sections 327 and 328 were intended to broaden the relief powers previously conferred by Section 210

---

account of the expiring life of patents only the actual cost thereof and not an estimated value as of March 1, 1913, or any other date, will be considered." See Regulations 41 (1918 ed.), Art. 42, requiring the consideration of reasonable allowances for depletion, depreciation and obsolescence in the computation of invested capital under the War Excess Profits Tax provisions of 1917.

of the War Revenue Act of 1917, *supra*.[20] *Williamsport Co.* v. *United States*, 277 U.S. 551, 558. Because of the possibility that the normal method of computing the tax might place a premium on overcapitalization in some cases and result in extreme hardship in others, it was believed "necessary to provide a special method of determining the tax for those cases in which the ordinary method of assessment would result in grave hardship or serious inequality." S. Rep. No. 617, 65th Cong., 3d Sess., p. 14 (1939–1 Cum. Bull. (Part 2) 117, 127). In the view of Congress, "No part of Title III [the excess profits tax provisions] is as important as the so-called relief provisions." S. Rep. No. 617, *supra*, p. 14. The relief granted in Sections 327 and 328 was highly discretionary, and both the propriety of relief for particular taxpayers and the amount of such relief depended upon judgments of the Commissioner of Internal Revenue with respect to matters not entirely subject to proof or disproof. The Commissioner's determinations, moreover, were not subject to review in the courts. See *Williamsport Co.* v. *United States, supra*; *Heiner* v. *Diamond Alkali Co.*, 288 U.S. 502; and *Welch* v. *Obispo Oil Co.*, 301 U.S. 190.

In the same Act, the peculiar problems of the oil, gas and mining industries under excess profits tax-

[20] The expansion of the relief provisions in the 1918 Act was summarized in H. Rep. No. 767, 65th Cong., 2d Sess., pp. 19–20 (1939–1 Cum. Bull. (Part 2) 86, 99–100).

ation were recognized.[21] Section 337 of the excess profits tax title provided:

> That in the case of a bona fide sale of *mines, oil or gas wells*, or any interest therein, *where the principal value of the property has been demonstrated by prospecting or exploration and discovery work* done by the taxpayer, the portion of the tax imposed by this title attributable to such sale shall not exceed 20 per centum of the selling price of such property or interest. [Emphasis added.]

Section 211(b) of the income tax provisions of the Revenue Act of 1918, which limited the surtax rate, was identical.[22]

S. Rep. No. 617, 65th Cong., 3d Sess., p. 6 (1939–1 Cum. Bull. (Part 2) 117, 120–121), contained the following explanation of these provisions:

---

[21] The statute's special provisions regarding income from patents and secret processes were contained in Section 326(a)(4) and (5), limiting the valuation in the computation of "invested capital" to be placed on "intangible property" paid in for stock. "Intangible property" was defined as "patents, copyrights, secret processes and formulae, good will, trade-marks, trade-brands, franchises, and other like property". Section 325(a). S. Rep. No. 617, 65th Cong., 3d Sess., p. 14 (1939–1 Cum. Bull. (Part 2) 117, 126–127), states in this connection: "Patents and copyrights give rise to as much abuse in connection with overcapitalization as other forms of intangible property".

[22] See Regulations 45 (1920 ed.), Arts. 13 and 971–972, with respect to the computation of the surtax and excess profits tax upon the sale of mineral deposits discovered by the taxpayer. Compare Art. 40, as amended by T.D. 3206, 5 Cum. Bull. (1921) 87, 88, providing for the tax on income from the sale of patents on the basis of the difference between the sale price and the cost or March 1, 1913, value, less depreciation, which makes no reference to the concept of discovery value.

Gains Derived From Prospecting, Exploration, or Discovery

> The prospector for mines or oil and gas frequently expends many years and much money in fruitless search. When he does locate a productive property and comes to settle it seems unwise and unfair that his profit be taxed at the maximum rate as if it were ordinary income attributable to the normal activities of a single year. *To stimulate prospecting and exploration, the committee has limited the surtax to 20 per cent of the selling price in the case of a bona fide sale of mines, oil or gas wells where the principal value was demonstrated by prospecting, exploring, or discovery work done by the taxpayer* (sec. 211b, p. 18). A similar limitation has been imposed by the war excess-profits tax applicable to gains derived by a corporation from the bona fide sale of such mines, oil or gas wells (sec. 337, p. 107). Special provision is also made for increased depletion allowance in the case of such properties (sec. 214 (10), p. 28; and sec. 234(9), p. 58). [Emphasis added.]

In the Conference Report, the House agreed to the addition of Sections 211(b) and 337, providing relief to the mining, oil and gas industries with respect to both surtax and excess profits rates. H. Conference Rep. No. 1037, 65th Cong., 3d Sess., pp. 47, 70 (1939-1 Cum. Bull. (Part 2) 130, 134, 150).

The Congressional Hearings concerning Sections 211(b) and 337 of the Revenue Act of 1918 contain further explanation of the Congressional purpose to aid the oil, gas and mining industries by the enact-

ment of those sections.[23] The relief provisions in question were adopted initially when many minerals were needed urgently for war purposes. The representatives of the oil industry informed the Congress that increased production of oil depends largely upon the encouragement of exploration and prospecting since the production of existing wells necessarily declines from the beginning.[24] As a result of the high surtax and excess profits tax rates, "wildcatters" or prospectors who had discovered oil were being discouraged from the usual practice of selling their discovered wells to developers and engaging in further

[23] See, generally, Senate Hearings, Revenue Act of 1918, pp. 356–393; House Hearings, Revenue Act of 1918, Part I, pp. 437–528.

[24] The representative of the National Petroleum War Service Committee stated (Senate Hearings, Revenue Act of 1918, p. 357): "* * * unless in the precarious enterprise of crude-oil production, which does not depend upon anything else except new discovery and new development, there is a fair encouragement of new development; an opportunity for that exploration which makes what is known as the 'wildcatter' in the oil world, precisely the same as the 'prospector' in the mining world, this country unquestionably, if the figures of the oil producers of the United States are accurate, faces a genuine and serious shortage in crude oil, at a time when we are fast demanding a very much increased supply for the manifold necessities of ourselves and our allies across the seas". The statement of the Mid-Continent Oil & Gas Association and the Texas Gulf Coast & Louisiana Oil & Gas Association cautioned (Senate Hearings, Revenue Act of 1918, p. 392): "It is proper and necessary in the consideration of this legislation from any angle to keep in mind the fact that the production of all wells rapidly declines from the beginning."

exploration.[25] The solution adopted in Sections 211(b) and 337 of the Revenue Act of 1918, in accordance with the recommendations of the oil and gas industry,[26] was the placing of a limit on the surtax and excess profits tax rates applicable to sales of discovered mines, oil or gas wells. As demonstrated more fully in Point II B, *infra*, pp. 32–37, these pro-

[25] The statement of the Mid-Continent Oil & Gas Association and the Texas Gulf Coast & Louisiana Oil & Gas Association with respect to this problem was (Senate Hearings, *supra*, p. 391): "One of the characteristic and essential features of oil and gas producing is the individual or concern of small means engaged in prospecting. The flowing well is the rare exception and, as a rule, after the discovery of a producing property a large additional investment is necessary for development. It has been customary for the small operator to borrow through local banks this necessary money, both banker and operator knowing that the income from the property can not be expected to pay the loans when due, or even within a period proper and suitable for loans by banks of that type. In the past this has been possible because the operator has purposed selling the property when it had reached a suitable point of development, but treatment of all of the profits as income in the one year in which the sale is made and as subject to the existing excess profits tax rates has stopped all sales of producing oil properties and is thus inevitably stopping prospecting by individuals and concerns of small means. The House bill with its increased rates under either alternative would greatly accentuate this unfortunate situation".

[26] The statement of the oil and gas associations quoted in the preceding two footnotes concluded (Senate Hearings, Revenue Act of 1918, pp. 392–393): "In view of the importance and close relationship existing between sales of producing oil and gas properties and the continuance of the drilling in search of new production so vitally necessary to the prosecution of the war, the net income derived from such sales, bona fide made, where not more than a 50 percent interest is retained by the seller, should not be subjected to a greater tax than 20 percent".

visions have been retained as a form of special relief for the mining, oil and gas industries, almost without interruption, in all the revenue laws of the succeeding years with respect to both income taxes and excess profits taxes. Thus, Section 105 of the 1939 Code (Appendix, *infra*, p. 1a) is virtually identical, even in terminology, with Section 211(b) of the Revenue Act of 1918. Section 456(a)(2)(B) of the 1939 Code is the companion excess profits tax provision, modified in accordance with the altered statutory framework and expanded to cover the gradual sale of the wasting asset.[27]

The Revenue Act of 1918 also provided for the allowance of depletion deductions in the case of mines, oil and gas wells, other natural deposits, and timber, and stated that in certain cases the depletion allowance, for mines, oil and gas wells only, shall be based

[27] It may be noted that the income tax provision, Section 105 of the 1939 Code, does not reflect an expansion similar to Section 456(a)(2)(B) so as to cover the gradual sale of the wasting asset—for the obvious reason that no similar expansion was necessary for income tax purposes in view of the intervening marked expansion of the percentage depletion provisions, which appeared in Section 114(b)(3) and (4) of the 1939 Code.

It may be added that, of course, for present purposes, far more significant is the direct relationship in the terminology between Section 456(a)(2)(B) and Section 721(a)(2)(C) of the 1939 Code and Section 327 of the 1918 Act.

In this connection, it might also be pointed out that there is no direct correlation between Sections 456(a)(2)(B) and 721(a)(2)(C) of the 1939 Code and Sections 327(d) and 328 of the 1918 Act—since the latter were the original broad general relief provisions in the World War I Excess Profits Tax Law, the general concept of which found its way really into Section 722 of the World War II law.

upon discovery value. Section 234(a)(9), concerned with the computation of the net income subject to the tax on corporate revenue, allowed as a deduction:

> In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case, based upon cost including cost of development not otherwise deducted: *Provided,* That in the case of such properties acquired prior to March 1, 1913, the fair market value of the property (or the taxpayer's interest therein) on that date shall be taken in lieu of cost up to that date: *Provided further, That in the case of mines, oil and gas wells, discovered by the taxpayer, on or after March 1, 1913, and not acquired as the result of purchase of a proven tract or lease, where the fair market value of the property is materially disproportionate to the cost, the depletion allowance shall be based upon the fair market value of the property at the date of the discovery, or* within thirty days thereafter; such reasonable allowance in all the above cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary. * * *. [Emphasis added.]

Section 214(a)(10) was identical with respect to the deduction allowed persons other than corporations.[22]

[22] See Treasury Regulations 45 (1920 ed.) Arts. 201–226, the detailed Regulations concerning discovery depletion applicable to mines and oil and gas wells. Compare Art. 167, providing for the depreciation of patents on a cost or March 1, 1913, value (the latter applicable "only when affirmative and satisfactory evidence of such value is offered") without reference to discovery value.

In S. Rep. No. 617, 65th Cong., 3d Sess., p. 8 (1939–1 Cum. Bull. (Part 2) 117, 122), it was explained:

> For the purpose of depletion allowance in the case of properties acquired prior to March 1, 1913, the provision of the present law, omitted in the House bill, has been restored by the committee, so that in the case of such properties the basis for the depletion allowance shall be the March 1, 1913, valuation; but a proviso has been added that where mines or oil and gas wells have been discovered by the taxpayer on or after March 1, 1913, and not acquired as a result of the purchase of a proven tract or lease, and where the fair market value is materially disproportionate to the cost, the depletion allowance shall be based upon the fair market value of the property at the date of the discovery or within 12 months thereafter (sec. 214a, 10, and sec. 234a, 9).[29]

Section 234(a)(9) of the Revenue Act of 1918 was enacted as part of the Congressional program to obtain increased oil production by providing incentives to "wildcatters" or prospectors. See footnotes 24 and 25, *supra*. Previously, although a "wildcatter" had experienced great losses in prior years, he was taxed at high rates on all income in excess of his immediate expense in the year of his discovery. The oil industry representatives had suggested that this inequity be remedied by allowing depletion on the

[29] The House receded from its more limited relief provision with an amendment changing the valuation period from 12 months to 30 days. (H. Conference Rep. No. 1037, *supra*, p. 50 (1939–1 Cum. Bull. (Part 2) 130, 136).

basis of discovery value rather than cost, or by permitting the carry-over of costs.[30]

To provide equitable tax treatment of prospectors, the concept of depletion on the basis of discovery value (Sections 214(a)(10) and 234(a)(9), Revenue Act of 1918, *supra*) has been retained in succeeding revenue laws, and the suggestion of the oil industry in 1918 that costs be carried over against future income was

---

[30] The Oil and Gas Producers' Association of West Virginia recommended (House Hearings, Revenue Act of 1918, Part I, pp. 497–498):

> As it requires the investment of capital at great risk to determine the value of prospective oil or gas properties, such properties should be valued after oil or gas has been discovered thereon for the purpose of taxation. This would give the prospector an incentive by giving him some benefit or credit for the increased valuation which he might create at the risk of losing his investment. * * *

The recommendation of the Mid-Continent Oil & Gas Association and the Texas Gulf Coast and Louisiana Oil & Gas Associations was as follows (Senate Hearings, Revenue Act of 1918, p. 393):

> 6. Under existing law and the Regulations of the Treasury Department, the cost of discovery of deposits of petroleum—that is, money spent in unsuccessful prospecting and drilling dry holes—must be treated as a loss, unless there is sufficient income during the taxable year to permit its deduction as an expense.
>
> Obviously, this is a great and unjustifiable hardship and burden to the taxpayers engaged in such a hazardous and uncertain industry, the returns from which are so necessarily irregular that several years of losses frequently intervenue between profitable discoveries.
>
> Clearly, money so expended in such an industry should either be treated as capital invested and returnable through depletion or as an expense to be deducted from income when the same is attained in some subsequent year.

adopted later in excess profits taxation.[31] Section 114(b)(2) of the 1939 Code (Appendix, *infra*, pp. 1a–2a) allows depletion based on discovery value. In Section 456(a)(2)(B) of the 1939 Code, the same concept is applied: Companies in the extractive industries are permitted to attribute to other years certain excess profits to the extent of the discovery value of their properties. See also Section 721(a)(2)(C) of the 1939 Code.

Examination of the Revenue Act of 1918 and of its extensive legislative history thus clearly demonstrates that the concept of special treatment of income derived from "exploration, discovery, or prospecting" was adopted for the explicit purpose of aiding the natural resources industries. The statutory terms have not been changed, and the relief in question remains applicable only to these industries.

B. *In the period between the two World Wars, the 1918 provisions for special treatment of income from exploration, discovery and prospecting were retained in the income tax laws through 1938, and applied only to the natural resources industries*

1. Provisions for taxation of proceeds from the sale of discovered mining, oil, or gas properties

The provisions of Sections 211(b) and 337 of the Revenue Act of 1918 limiting the tax on the proceeds from the sale of discovered mining, oil or gas properties, were retained as Sections 211(b) and 337 of the Revenue Act of 1921, c. 136, 42 Stat. 227, Title III of which imposed, for the year 1921, a tax similar to

[31] See Section 433(b)(9)(B) (Appendix, *infra*, p. 7a) and Section 711(b)(1)(I) (Appendix, *infra*, p. 32a) of the 1939 Code.

the 1918 excess profits tax provisions. This section was re-enacted, virtually without change, as Section 211(b) of the Revenue Acts of 1924, c. 234, 43 Stat. 253, and 1926, c. 27, 44 Stat. 9, and as Section 102(a) of the Revenue Acts of 1928, c. 852, 45 Stat. 791, and 1932, c. 209, 47 Stat. 169.

In the Revenue Act of 1934, c. 277, 48 Stat. 680, the provision in question was omitted because overproduction in the oil and gas industries made the encouragement of prospecting undesirable.[32]

However, in the Revenue Act of 1936, c. 690, 49 Stat. 1648, the provision limiting the tax on the proceeds from sales of discovered oil and gas properties was reinstated, as Section 105, with a 30 percent limit on the rate of tax. The Senate Finance Committee's Report (S. Rep. No. 2156, 74th Cong., 2d Sess., p. 18 (1939–1 Cum. Bull. (Part 2) 678, 689)) explained the application of the reinstated provision as follows:

> The bill as reported inserts a provision not found in the House Bill but similar to provisions contained in Revenue Acts prior to 1934, limiting the surtax in cases of taxpayers who sell oil or gas property where the principal

[32] H. Rep. No. 704, 73d Cong., 2d Sess., p. 25 (1939–1 Cum. Bull. (Part 2) 554, 572), states:

> This provision apparently was inserted in the law to encourage the development of new mines and oil wells. In the present state of overproduction there is no need to continue this provision.

S. Rep. No. 558, 73d Cong., 2d Sess., p. 30 (1939–1 Cum. Bull. (Part 2) 586, 609), states:

> In the present state of overproduction there is no need to continue this provision, which taxes large profits from the sales of certain kinds of property on a different basis from that applicable to property generally.

> value of the property has been demonstrated by *prospecting* or *exploration* and *discovery* work done by the taxpayer. The effect of the provision is to limit the surtax on that portion of the individual's net income attributable to the sale of such properties to not more than 30 percent of the selling price of the property or interest. It was brought to the attention of the committee that the effect of the omission in the 1934 act of a similar provision was, in many cases, to prevent the sale of such properties and thus a tax loss has resulted and individuals have been discouraged from embarking upon or continuing such enterprises. The result was to throw the business into the hands of corporations which, being subject only to the corporation-tax rate, would pay less tax than individuals would. It is believed that the result of the proposed change will be to stimulate individuals to develop oil and gas properties and to sell, thus increasing the tax yield from this source. [Emphasis supplied.]

The 1936 provision was retained as Section 105 of the Revenue Act of 1938, c. 289, 52 Stat. 447,[33] and finally appeared as Section 105 in the 1939 Code.

It is notable that, throughout the long history of this relief provision of the tax laws, it always has been applied (S. Rep. No. 2156, *supra*) "where the principal value of the property has been demonstrated by *prospecting or exploration and discovery work*

[33] In the 1936 Act the phrase in question was changed to "prospecting * * * or [instead of "and"] discovery work," and the section as a whole was limited to oil or gas property. As indicated *supra*, it has been carried forward in this form. See also *infra*, pp. 69–72.

done by the taxpayer." [Emphasis added.] The provision never has had reference to relief for any class of taxpayers except discoverers of mines and oil and gas properties, although, as indicated above, the section has been considered and debated many times and always has been couched in the very words on which the taxpayer here relies. Throughout the history of this section, in both the income and excess profits sections of the tax laws, "exploration," "discovery" and "prospecting" have been treated by Congress as *words of art* having application *only* to the mining, oil and gas industries.

2. Provisions allowing depletion of oil, gas, and mining properties on the basis of discovery values

Sections 214(a)(10) and 234(a)(9) of the Revenue Act of 1918, *supra,* which provided for the allowance of a deduction for depletion on the basis of discovery value in the case of mines and oil and gas wells, were retained under the same section numbers in the Revenue Act of 1921, *supra.* The following proviso was inserted in each section:

> * * * *And provided further,* That such depletion allowance based on discovery value shall not exceed the net income, computed without allowance for depletion, from the property upon which the discovery is made, except where such net income so computed is less than the depletion allowance based on cost or fair market value as of March 1, 1913 * * *.

The added proviso was designed to assure that discovery depletion could be applied only to income from

the designated industries and could not be used to offset the income of taxpayers from other businesses.[34]

Section 204(c) of the Revenue Act of 1924, *supra*, limited the discovery depletion allowance with respect to income from mines, oil and gas wells, to not more than 50 per cent of the net income from the property upon which the discovery was made.

The corresponding section of the Revenue Act of 1926, *supra*, Section 204(c)(1), limited discovery value depletion to mines. Depletion of oil and gas wells was allowed on the basis of a percentage of gross income from the property during the taxable year rather than on discovery value. Section 204(c)(2).[35]

---

[34] S. Rep. No. 275, 67th Cong., 1st Sess., p. 15 (1939–1 Cum. Bull. (Part 2) 181, 191), states:

> * * * in order to make it certain that the depletion deduction when based upon discovery value shall not be permitted to offset or cancel profits derived by the taxpayer from a separate and distinct line of business, it is provided that the depletion allowance based on discovery value shall not exceed the net income, computed without allowance for depletion, from the property upon which the discovery is made, except where such net income so computed is less than the depletion allowance based on cost or the fair market value as of March 1, 1913 * * *.

See also H. Conference Rep. No. 486, 67th Cong., 1st Sess., p. 25 (1939–1 Cum. Bull. (Part 2) 206, 215), to the same general effect.

[35] See S. Rep. No. 52, 69th Cong., 1st Sess., pp. 17–18 (1939–1 Cum. Bull. (Part 2) 332, 345–346); H. Conference Rep. No. 356, 69th Cong., 1st Sess., pp. 31–32 (1939–1 Cum. Bull. (Part

The section relating to "Discovery value in case of mines" was re-enacted as Section 114(b)(2) of the Revenue Act of 1928, *supra*. Under the same number, the section remained essentially unchanged in the Revenue Act of 1932, *supra*. Percentage depletion was applied in the case of metal, coal and sulphur mines. Section 114(b)(4).[36] The "discovery value" provision of Section 114(b)(2) was carried forward, slightly clarified, in the Revenue Act of 1934, *supra*, and then re-enacted without change in the 1936 and 1938 Revenue Acts, *supra*, under the same number.

In sum, the concept of allowing a deduction from income for depletion on the basis of discovery value has been a part of the tax laws since 1918. Its only application has been to the mining, oil and gas industries.

---

2) 361, 362–363); 67 Cong. Record, Part 3, pp. 3018–3019; Part 4, pp. 3761–3763, to the effect that difficulty had been experienced in administering the discovery value depletion provisions in the case of oil and gas wells because of the policy of attempting to allow depletion on the basis of the ultimate value of the oil or gas in the ground in the case of each well. This abandoned policy may be contrasted with the more flexible and practical present approach of ascertaining the discovery value of oil and gas wells by reference to expert estimates of the value of the pool on the date of discovery in the active and established market for leases of such properties. See Rev. Rul. 236, 1953–2 Cum. Bull. 236.

[36] Percentage depletion provisions, broadly expanded, found their way into the 1939 Code in Section 114(b)(3) and (4).

C. *During the Second World War period, the 1939 Code contained separate provisions for relief, both for income tax and excess profits tax purposes, as to income from exploration, discovery and prospecting with reference only to the natural resources industries—and excess profits tax relief for other taxpayers was provided in other sections, utilizing other terminology*

1. The general pattern of the Second World War Excess Profits Tax Law, and its relief provisions

The Second World War excess profits tax law was patterned to some extent upon the World War I law, though with numerous modifications and additions. That law first appeared in a new subchapter (Subchapter E—Excess Profits Tax) which was added to Chapter 2 of the 1939 Code by Section 201 of the Second Revenue Act of 1940, c. 757, 54 Stat. 974, entitled "Excess Profits Tax Act of 1940," applicable to taxable years beginning after December 31, 1939." In the new subchapter, a tax was imposed by Section 710(a) (Appendix, *infra*, p. 29a) upon the "adjusted excess-profits net income" as defined in Section 710 (b), less the following: (1) a specific exemption (originally $5,000, later $10,000); (2) an "excess profits credit" computed under Section 712 (Appendix, *infra*, p. 33a); and (3) an unused excess profits credit adjustment computed in accordance with Section 710(c).[37] Section 711 (Appendix, *infra*,

[37] This statute was repealed, as to taxable years beginning after December 31, 1945, by Section 122(a) of the Revenue Act of 1945, c. 453, 59 Stat. 556.

[38] Subsection (c) of Section 710 was added by Section 2(b), Excess Profits Tax Amendments of 1941, c. 10, 55 Stat. 17, and amended by Section 204(b), Revenue Act of 1942, c. 619, 56 Stat. 798.

pp. 30a–33a) provided that the "excess profits net income" shall be the "normal-tax net income" (as defined in Section 13(a)(2) under Chapter 1 of the Code, relating to the income tax), with certain adjustments. Under Section 712(a), a corporation (if in existence prior to 1940) could take an excess profits credit computed either under Section 713 (Appendix, *infra*, pp. 33a–37a) on the basis of average net income during a so-called "base period", generally the years 1936 through 1939 (*ie.*, the "average base period net income", or the ABPNI),[39] or under Section 714 upon the basis of invested capital, whichever resulted in the lesser tax. Sections 715 through 720 contained the formula by which the invested capital credit was to be determined.

Following Section 720 are the provisions dealing with "abnormalities" and special situations. Relief for "abnormalities" was accorded primarily by Section 721, which granted relief with respect to "abnormalities" in income in the taxable year, and by Section 722 (Appendix, *infra*, pp. 41a–44a), which granted relief mainly with respect to "abnormalities" in the base period. In addition, some further relief was provided under Section 711(b)(1)(H), (I), (J), and (K) (Appendix, *infra*, pp. 31a–33a), by way of adjustments to a taxpayer's base period income, for unusual or "abnormal" deductions, etc.[40]

---

[39] For the sake of brevity, the initials "ABPNI" have been generally used to refer to the "average base period net income" under Section 713, while the initials "CABPNI" have been used to refer to the "constructive average base period net income" under Section 722.

[40] Subsections (J) and (K) were added to Section 711(b)(1) by Section 3, Excess Profits Tax Amendments of 1941, *supra*.

Viewing the law broadly, it is apparent that it taxed at high rates all profits above a certain level or norm, which was called the "excess profits credit" and which was computed either upon the basis of average income for a specified prior period (called the base period, generally the years 1936 through 1939) or upon the basis of invested capital, whichever resulted in the lesser tax—except that the law contained provisions granting relief from the resultant tax for certain so-called "abnormalities" and special situations.

The principal "abnormalities" provisions of the law (Section 721 and Section 722) were originally added to the Code by the Second Revenue Act of 1940, but they underwent considerable changes in subsequent Acts, being largely amplified by the Excess Profits Tax Amendments of 1941, c. 10, 55 Stat. 17, and by the Revenue Act of 1942, c. 619, 56 Stat. 798, with further occasional changes being made even thereafter. The relief provisions of Section 722 were finally changed (retroactively, to apply to all taxable years after 1939) by Section 222 of the Revenue Act of 1942, so as to provide, in substance, that a taxpayer could, under certain conditions, obtain relief upon the basis of a "constructive" average base period net income (*i.e.*, a CABPNI) if it could establish that its income during the base period was not normal for any of the reasons specified in the statute and if it could establish "what would be a fair and just amount representing normal earnings". Section 722(a). With respect to the *procedure* for obtaining relief, Section 722 was finally amended by Section 1 of the Act of

December 17, 1943, c. 346, 57 Stat. 601 (also retroactively to apply to all taxable years after 1939), so as to require, in substance, that a taxpayer must first pay its excess profits tax without the benefit of Section 722 and then seek relief under Section 722 by filing a claim therefor pursuant to the provisions of Section 322 of the Code, the so-called "claim for refund" section, "in accordance with regulations prescribed by the Commissioner with the approval of the Secretary". Section 722(d) of the Code. See, also, *Pohatcong Hosiery Mills* v. *Commissioner*, 162 F. 2d 146 (C.A. 3d); *United States* v. *Koppers Co.*, 348 U.S. 254.

In 1941, at the same time that Congress undertook the first major amplification of the two principal "abnormalities" sections (Sections 721 and 722) and added Section 711(b)(1) (J) and (K) in the Excess Profits Tax Amendments of 1941, it also added to the law Section 732(a), (b), and (c) (Appendix, *infra*, pp. 44a–45a) to deal specifically with the review of "abnormalities" questions by the Tax Court (then called the Board of Tax Appeals)[41] and to prohibit expressly the further review by any other court of any decision of the Tax Court on any of the "abnormalities" questions. The intent of Congress to limit the review of "abnormalities" questions was made unmistakably clear by its Committee Reports. H. Rep. No. 146, 77th Cong., 1st Sess., pp. 14–15 (1941–1 Cum.

[41] Previously, the jurisdiction of the Tax Court could be invoked only where the Commissioner had determined a deficiency, pursuant to Section 272 of the Code.

Bull. 550, 560–561), and S. Rep. No. 75, 77th Cong., 1st Sess., pp. 15–16 (1941–1 Cum. Bull. 564, 565). See, also, the series of decisions in the courts of appeals holding that the Tax Court's determinations under the "abnormalities" provisions of the Second World War law are not subject to judicial review. E.g., *Helms Bakeries* v. *Commissioner,* 263 F. 2d 642 (C.A. 9th), certiorari denied, 360 U.S. 903; *L. E. Carpenter & Co.* v. *Commissioner,* 264 F. 2d 230 (C.A. 3d); *United States Rubber Co.* v. *Commissioner,* 274 F. 2d 307 (C.A. 2d), certiorari denied, 363 U.S. 827; *Puget Sound Pulp & Timber Co.* v. *Commissioner,* 277 F. 2d 803 (C.A. 9th), certiorari denied, 364 U.S. 831; *Hewitt-Robins, Inc.* v. *Commissioner,* 282 F. 2d 868 (C.A. 3d).

Subsequently, by Section 222(c) of the Revenue Act of 1942, Congress added subsection (d) to Section 732 of the Code (Appendix, *infra,* pp. 45a–46a) to provide for the review by a "Special Division" of the Tax Court of the decisions by any division of the Tax Court of questions under Section 721(a)(2)(C) or Section 722 of the Code. This new feature was written into the law by Congress because of its awareness of the extremely complicated nature of the problems and issues involved. See H. Rep. No. 2333, 77th Cong., 2d Sess., p. 149 (1942–2 Cum. Bull. 372, 482); S. Rep. No. 1631, 77th Cong., 2d Sess., pp. 206–207 (1942–2 Cum. Bull. 504, 655); *Helms Bakeries* v. *Commissioner,* 236 F. 2d 3 (C.A. 9th).

In view of subsequent developments in the field of excess profits taxation, we examine in greater detail the provisions of Section 713, which provided for an excess profits credit upon the basis of *actual* average

earnings during the base period, *i.e.*, the ABPNI—as distinguished from Section 722, which provided for special relief for "abnormalities" by means of a credit arrived at upon the basis of a *constructive* average income for the base period, *i.e.*, the CABPNI.

The basic plan of Section 713 was to provide for an ABPNI arrived at by means of a computation reflecting the average yearly amount of earnings of a taxpayer for the four base period years—in other words, an arithmetical general average. See Section 713 (d) and (e). However, incorporated into Section 713 were two provisions which were aimed at affording a certain measure of relief in certain situations by means of automatic adjustments to be made in the computation of the ABPNI.

One of these provisions was contained in Section 713(e), with respect to the earnings for the lowest year in the base period, while the other was contained in Section 713(f), with respect to increased earnings in the last half of the base period. Section 713(e), as finally amended by Section 215 of the Revenue Act of 1942, was a provision designed to raise automatically the income for the poorest year in a taxpayer's base period, by the use of the so-called "75% rule"—whereby, if the earnings for one base period year were less than 75% of the average earnings for the other base period years, the earnings of that low year were raised automatically to an amount equal to 75% of the average for the other years.[42] See S. Rep. No. 1631, *supra*, pp. 45, 191

[42] Previously, for taxable years prior to 1942, instead of the "75% rule", Section 713(e) contained the so-called "deficit rule", whereby the largest deficit in any of the base period

(1942–2 Cum. Bull. 504, 541–542, 644); H. Conference Rep. No. 2586, 77th Cong., 2d Sess., pp. 60–61 (1942–2 Cum. Bull. 701, 718). Section 713(f)—adopted (in its final form) by Section 4 of the Excess Profits Tax Amendments of 1941—accorded some relief, also *automatically,* to taxpayers which experienced rapid growth during the base period. As to such taxpayers, Congress adopted the so-called "growth formula", granting a greater credit to corporations with earnings in the second half of the base period exceeding those in the first half—this, in order to reflect more equitably their earning power as of the time the excess profits tax became applicable. See H. Rep. No. 146, *supra,* pp. 3, 6–7 (1941–1 Cum. Bull. 550, 551, 553–554); S. Rep. No. 75, *supra,* pp. 3, 6–7 (1941–1 Cum. Bull. 564, 565).

In this connection, we note that the benefits provided for by the "75% rule" under Section 713(e) and the benefits of the so-called "growth formula" computation under Section 713(f) were alternatives to each other. See Section 713(d). See also S. Rep. No. 1631, *supra,* p. 191 (1942–2 Cum. Bull. 504, 644), and Treasury Regulations 112, Sections 35.713–1 (a) and (c)(2). The benefits of both Section 713(e) and Section 713(f) were, in turn, alternatives to relief under Section 722. In other words, the benefits of the automatic adjustments in the computation of the

---

years was eliminated in arriving at the ABPNI. See Section 713(e), as amended by Sections 4 and 17 of the Excess Profits Tax Amendments of 1941, *supra.*

ABPNI under Section 713 and the special relief by means of a CABPNI under Section 722 were mutually exclusive. See *Dowd-Feder* v. *Commissioner,* 173 F. 2d 673 (C.A. 6th); *Dayton Rubber Co.* v. *Commissioner,* 249 F. 2d 2 (C.A. 6th); *United States Rubber Co.* v. *Commissioner, supra.*[43]

As already noted, Section 721 was originally added to the Code by the Second Revenue Act of 1940, later amplified by the Excess Profits Tax Amendments of 1941, and further amended by the Revenue Act of 1942, so as to accord relief to a taxpayer, under certain conditions, with respect to "abnormal" income received during a taxable year but really attributable to other years. The general purpose of Section 721 has been aptly stated to be "to relieve the burden of the excess profits tax in certain hardship cases by permitting the reallocation" of certain portions of the net abnormal income of a taxpayer from the year of its realization to other years to which it is attributable. *Southwestern Oil & Gas Co.* v. *Commissioner,* 6 T.C. 1124, 1129. As originally added to the Code in 1940, Section 721 provided relief with respect only to

[43] Although a taxpayer reconstructing its base period earnings under Section 722 was not entitled to use the "growth formula" as such, it was recognized that, in a proper case, *true growth* could be considered and reflected into a reconstruction of base period earnings to the extent reasonable and consistent with Section 722. See Section 35.722-2(b)(1) of Treasury Regulations 112, as amended by T.D. 5415, 1944 Cum. Bull. 404, and T.D. 5566, 1947-1 Cum. Bull. 72. See also Treasury Department's Bulletin on Section 722 (November, 1944), pp. 154–156.

income falling within any of six specifically enumerated classes, but by the amendments in 1941 the definition of "abnormal income" in Section 721(a)(1) was enlarged so as to embrace income of any other class if it was abnormal for the taxpayer to derive income of such class or if its income of that class for the taxable year was in excess of 125 per cent of its income of the same class for the prior four taxable years.

Both Sections 721 and 722 were broad, general relief statutes, and there was a substantial degree of overlapping of their applicability. Their interrelationship is illustrated by that portion of Section 721(a)(2)(C) affording relief with respect to income resulting from "research, or development of tangible property, patents, formulae, or processes" and by those portions of Section 722(b)(4) granting relief to taxpayers who "either during or immediately prior to the base period * * * changed the character of the business"—particularly with respect to changes in character of the business due to a "change in [method of] operation", a "change in the capacity for production or operation", or due to a "difference in the products or services furnished".[4] Consequently, many taxpayers who claimed relief under Section 721 also made claims under Section 722. See, *e.g.*, *Commissioner* v. *Smith Paper*, 222 F. 2d 126 (C.A. 1st); *Crowell-Collier Publishing Co.* v. *Commissioner*, 259 F. 2d 860 (C.A. 2d), certiorari denied, 358 U.S. 928;

[4] See also Section 721(f); Treasury Regulations 112, Section 35.721-7; Bulletin on Section 722, *supra*, pp. 156–158.

Don Baxter, Inc. v. *Commissioner,* 29 T.C. 1027. See also H. Rep. No. 2333, 77th Cong., 2d Sess., p. 24 (1942–2 Cum. Bull. 372, 393). In the litigation of claims for relief under Section 721(a)(2)(C) with respect to new products or processes, it was established that relief under that section involved discretionary determinations similar to those necessary under Section 722. The Tax Court held that the portion of a corporation's increased income due to generally improved business conditions and not attributable to prior years under Section 721 is "a matter of opinion." *Rochester Button Co.* v. *Commissioner,* 7 T.C. 529, 553; *Pantasote Leather Co.* v. *Commissioner,* 12 T.C. 635. The discretionary nature of relief under Section 721(a)(2)(C) was emphasized further by the Tax Court's rulings that the allocation of profits as resulting from "research, or development" or from such nonqualifying factors as management, sales efforts, efficient use of physical facilities, etc., must be made "by exercising common sense and judgment," and that "It is entirely possible that the allocation made by one person would never match that made by another." *Ramsey Accessories Mfg. Corp.* v. *Commissioner,* 10 T.C. 482, 489. See *Eitel-McCullough, Inc.* v. *Commissioner,* 9 T.C. 1132; *Keystone Brass Works* v. *Commissioner,* 12 T.C. 618; *Pantasote Leather Co.* v. *Commissioner, supra.*

As a result of such problems of apportionment and proof, many taxpayers who made claims with respect to newly developed products only under Section 721

(a)(2)(C) were granted no relief.[45] See *Eitel-McCullough, Inc.* v. *Commissioner, supra; Keystone Macaroni Manufacturing Co.* v. *Commissioner,* 18 T.C. 1078; *E. W. Williams Publications, Inc.* v. *Commissioner,* 25 T.C. 282. See, also, *L. E. Carpenter & Co.* v. *Commissioner,* 29 T.C. 562, review dismissed for lack of jurisdiction, 264 F. 2d 230 (C.A. 3d), where relief under Section 721(a)(2)(C) was denied because of the taxpayer's failure to establish that profits resulted from research rather than mere mechanical modifications of machinery for use in known processes. Other taxpayers, having shown that they were entitled to something (see *Cohan* v. *Commissioner,* 39 F. 2d 540 (C.A. 2d)), received only a portion of the relief claimed under Section 721. See *Rochester Button Co.* v. *Commissioner, supra; Ramsey Accessories Mfg. Corp.* v. *Commissioner, supra; Keystone Brass Works* v. *Commissioner, supra; Pantasote Leather Co.* v. *Commissioner, supra.* Despite the overlapping of the provisions of Sections 721 and 722, most taxpayers apparently reached the conclusion that since both sections involved the risks of submitting to discretionary administrative determinations, it was to their advantage to seek the greater relief possible under Section 722[46]—and by 1950,

[45] Problems of apportionment did not impede relief under Section 721(a)(2)(C) with respect to income from "exploration, discovery [or] prospecting" in the mining industries. See *Richey* v. *Commissioner,* 19 T.C. 926.

[46] See Bulletin on Section 722, *supra,* pp. 50–52, 116–117, with respect to relief for taxpayers introducing new products. See, also, *Avey Drilling Machine Co.* v. *Commissioner,* 16 T.C. 1281; *Morgan Construction Co.* v. *Commissioner,* 23 T.C. 242; and cf. *Don Baxter, Inc.* v. *Commissioner, supra.*

more than 19,000 corporations had instituted 54,000 cases under Section 722. See House Hearings, Excess Profits Tax Act of 1950, p. 47.

In summary, it is apparent that the two principal relief provisions of the Second World War excess profits tax law (Sections 721 and 722) were closely correlated, had overlapping functions, and in practical application vested a great amount of discretion in the Commissioner, with review only by the Tax Court. That was in accordance with the basic design of the law, expressed as follows in the House Ways and Means Committee Report on the Excess Profits Tax Amendments of 1941 (H. Rep. No. 146, 77th Cong., 1st Sess., p. 2 (1941–1 Cum. Bull. 550–551)):

> Experience with excess-profits taxes, both in the United States and abroad, has demonstrated conclusively that relief in abnormal cases cannot be predicated on specific instances foreseeable at any time. The unusual cases that are certain to arise are so diverse in character and unpredictable that relief provisions couched in other than general and flexible terms are certain to prove inadequate.
>
> For these reasons, the present legislation attempts to provide, both by specific terms and in carefully guarded general terms, a set of flexible rules which should alleviate at least the bulk of the severe hardship cases which may arise.

2. The terms "exploration", "discovery", and "prospecting" were used to provide special treatment, as abnormal income, for income derived from the oil, gas and other natural resources industries.

In Section 721(a)(2)(C), the World War II statute provided relief for a class of abnormal income, including "Income resulting from *exploration, discovery, prospecting* * * * or any combination of the foregoing, extending over a period of more than 12 months * * *." (Emphasis added.) The income granted relief by the quoted provision was income from the same natural resources which had been found, after extended hearings, entitled to special treatment in Section 337 of the excess profits tax title of the Revenue Acts of 1918 and 1921, *supra*. The very terms emphasized above are the same as those previously used in excess profits tax and income tax laws to deal specially with income from natural resources. See 1939 Code Sections 105 and 114(b)(2) and the history of those sections since 1918, *supra*. As always in the past, the words "exploration," "discovery," and "prospecting" in the tax law had reference only to the oil, gas and other natural resources industries and were employed for the purpose of providing special relief treatment for income derived from "discovery" in those industries only.[47] In-

[47] As indicated, *supra*, Section 721(a)(2)(C) was integrated within the pattern of Sections 721 and 722 and of the statute as a whole, which provided general discretionary relief for a wide variety of situations and taxpayers. Even Section 721(a)(2)(C) itself contained provisions for relief of income from "research, or development of tangible property, patents, formulae, or processes." See the provisions of Section 721(a)(2) quoted in full in the Appendix, *infra*, pp. 37a–38a.

deed, in conference, Section 721(a)(2)(C) was rewritten so that its language would conform to provisions relating to income from discovery in the oil, gas and mining industries appearing elsewhere in the Code. Sections 105 and 114(b)(2), *supra*.[48]

At the hearings concerning the proposed excess profits tax, representatives of the oil, gas and natural resources industries presented extensive testimony concerning the need for favorable tax treatment of income from *exploration, discovery* and *prospecting* in these industries. Thus, there was extensive testimony as to the hazards of exploration and prospect-

[48] As originally written, subsection (a)(2)(C) provided relief as follows (H. Conference Rep. No. 3002, 76th Cong., 3d Sess., p. 50 (1940-2 Cum. Bull. 548, 556)):

> (3) Income resulting from the exploration, discovery, prospecting, research, or development of tangible property, patents, formulas, or processes, or any combination thereof, by the taxpayer or any of its predecessors, providing that such exploration, etc., extended over a period of more than 1 year * * *.

In Conference, the subsection was rewritten to provide that (H. Conference Rep. No. 3002, *supra*, p. 51 (1940-2 Cum. Bull. 548, 556)):

> The exploration, etc., from which the income is derived must be the taxpayer's own exploration. Income resulting from activities of such a character carried on by a predecessor corporation is not entitled to the treatment provided in section 721.

The change increased the similarity of the wording to that employed with respect to income from discovery in the oil, gas and mining industries in Sections 105 and 114(b)(2) of the Code, *supra*.

Separate provisions according to taxpayers generally the benefit of the experience of predecessor corporations, and the like, were contained in Supplement A of the law, Sections 740 and 742 of the Code.

ing, the dependence of the mineral developing industries on continued new *discoveries,* and the need for tax relief to furnish incentive to encourage "wildcatters" and prospectors to take risks in the search for mineral discoveries. Joint Hearings on Excess Profits Taxation, August, 1940, pp. 224–227; Senate Hearings on the Second Revenue Act of 1940, pp. 217–218, 328–329, 373–374. To conform with the relief afforded them under the income tax laws and prior excess profits tax statutes, representatives of natural resources companies urged that "the special relief provision should be considerably broadened, probably under provisions similar to those of prior acts", and should be administered by a special, independent board. Joint Hearings, *supra,* pp. 285–286; Senate Hearings, *supra,* p. 285. They specifically recommended that (Senate Hearings, *supra,* p. 374):

> There should be provided a deficiency carry-over or the excess tax should be levied on the average income of several years. That is because * * * this mining business is an up-and-down business * * *."

On the floor of the Senate, the subsection in question was discussed in terms of the oil, gas and mining industries. See 86 Cong. Rec. 12174–12177, 12919.[49]

---

[49] Compare the similar suggestion made in connection with the excess profits tax provisions of the Revenue Act of 1918, *supra.*

[50] The following example was presented by Senator King of Utah as illustrative of the operation of the subsection in the case of a mineral discovery (86 Cong. Rec. 12177):

> * * * if a mining corporation has been working for a num-

The relief granted the natural resources industries by Section 721(a)(2)(C) constituted only one aspect of the special treatment accorded those industries. Special treatment is also made available in the section dealing with adjustments to be made to normal tax net income in the computation of excess profits net income. Section 711(a)(1)(I), (a)(2)(K), and (b)(1)(I). In the case of corporations engaged in the mining of certain strategic minerals, Section 731 provided for the exemption from the excess profits tax of "the portion of the adjusted excess profits net income attributable to such mining in the United States". Section 735 contained special provisions relating to "Nontaxable Income from Certain Mining and Timber Operations, and from Natural Gas Properties". That section—commonly referred to as the "exempt excess output" provision—granted exemption from the excess profits tax for income derived from exceptionally high output of depletable resources and, at the option of the taxpayer, also granted exemption for bonus payments made by the Government to encourage such production. See also Section 722(f). The purpose of these sections was to encourage exploration and prospecting, to achieve the discovery of new mineral resources and increased

ber of years—say, 10 years—and a windfall comes on the tenth year, there would be no exception with respect to the normal income tax, but, for the purposes of the excess-profits tax, the amount would be considered to cover 5 years, and the windfall would be allocated to a number of years rather than to the year in which it was paid.

579949—61——5

production from old mines deemed particularly essential to the national defense. See S. Rep. No. 673, Part 1, 77th Cong., 1st Sess., pp. 13–14 (1941–2 Cum. Bull. 466, 477–478); H. Rep. No. 2333, 77th Cong., 2d Sess., pp. 27, 149 (1942–2 Cum. Bull. 372, 394–395, 482); S. Rep. No. 1631, 77th Cong., 2d Sess., pp. 38–40, 186–188, 205, 207, 211 (1942–2 Cum. Bull. 504, 536–538, 641–643, 654, 656, 658–659). These sections were coordinated with and designed to provide a solution to the same problems of the natural resources industries as was the portion of Section 721(a)(2)(C), *supra,* relating to income from "exploration, discovery, prospecting".

Sections 105 and 114(b)(2) of the income tax chapter of the 1939 Code, in effect throughout the period covered by the Second World War excess profits tax law, also provided special treatment for income from natural resources. Section 105 is the provision limiting to 30 percent the tax on income from sale of oil or gas properties "where the principal value of the property has been demonstrated by prospecting or exploration or discovery work done by the taxpayer". As we have shown, that provision had been added to the tax law in connection with the World War I excess profits tax (Revenue Act of 1918, *supra,* Sections 211(b) and 337) and, with only a brief interruption, has been retained continuously since then. Section 114(b)(2) provided for depletion on the basis of "discovery value" in the case of mines.[51] This section also

[51] The percentage depletion provisions, greatly expanded, were carried into the 1939 Code in Section 114(b) (3) and (4).

has been traced, *supra*, to the Revenue Act of 1918 (Sections 214(a)(10), 234(a)(9), *supra*).

Section 728 of the World War II excess profits tax law (Subchapter E of Chapter 2 of the Code) stated:

> The terms used in this subchapter [Subchapter E] shall have the same meaning as when used in Chapter 1 [the income tax chapter].

Accordingly, the terms "exploration", "discovery", and "prospecting", which in the cited income tax sections have always referred exclusively to the oil, gas, mining and other natural resources industries, necessarily had the same meaning in Section 721(a)(2)(C).

D. *During the Korean War period, the statute (Section 456) provided excess profits tax relief as to income resulting from exploration, discovery or prospecting with reference only to the natural resources industries—and by separate sections provided relief with respect to income derived from new products, industrial expansion and other sources*

1. The general pattern of the Korean War excess profits tax law, and its relief provisions

The 1950 or Korean War excess profits tax law was added as Subchapter D to Chapter 1 of the Code by Section 101 of the Excess Profits Tax Act of 1950, *supra*. This law was patterned in large measure upon the World War II law. Although the general scheme of this 1950 law was derived substantially from earlier statutes, much of the philosophy and many of the particular provisions of the 1950 statute reflected substantial departures from the prior law.

In the new Subchapter D, a tax was imposed by Section 430(a)(1) upon the "adjusted excess profits net income", as defined in Section 431, of every cor-

poration. This "adjusted excess profits net income" was computed by taking the "excess profits net income"—which, under Section 433 (Appendix, *infra*, pp. 5a–7a), was the "normal-tax net income" as defined in Section 13(a)(2), increased or decreased by certain adjustments—and subtracting therefrom either the total of (1) an excess profits credit, allowed under Section 434, and (2) an unused excess profits credit adjustment computed under Section 432, or a minimum of $25,000. The "excess profits credit" allowed under Section 434 (Appendix, *infra*, p. 8a) was computed under Section 435 (Appendix, *infra*, pp. 8a–13a) on the basis of average net income during the so-called "base period", generally the years 1946 through 1949, or under Section 436 upon the basis of invested capital, whichever resulted in the lesser tax. Thus the Korean War law, viewed broadly, also taxed all profits above a certain level or norm, called the "excess profits credit" and computed on the basis of average income or invested capital. See Sections 436 through 441 setting forth the detailed rules for the credit on the invested capital method.

The so-called "two-basket" approach of the World War II law, which had caused many administrative difficulties, was intentionally discarded. See H. Rep. No. 3142, 81st Cong., 2d Sess., p. 4 (1951–1 Cum. Bull. 187, 189), and S. Rep. No. 2679, 81st Cong., 2d Sess., pp. 4–5 (1951–1 Cum. Bull. 240, 242–243). Under the World War II system (as finally amended, effective beginning with the year 1942), the corporate income tax was imposed only on income not subjected to the excess profits tax. See *Ambassador Hotel Co.*

of Los Angeles v. *Commissioner*, 280 F. 2d 303, 305 (C.A. 9th), petition for certiorari filed on October 26, 1960 (No. 509, this Term). In the 1950 law, the income tax was imposed on the entire amount of taxable net income; the excess profits tax was an additional tax imposed on the "adjusted excess profits net income", computed generally as outlined above.

Apart from this structural change, one of the most significant areas of departure was in the so-called "relief" provisions—particularly, with reference to the grant of relief in those categories which had been covered in the World War II law under the "general relief" provisions of Section 722 (Appendix, *infra*, pp. 41a–44a).[52]

Although the Korean War law made several major changes with respect to the grounds upon which relief had been authorized under Section 722 of the earlier law—*i.e.*, with respect to the particular "abnormalities", conditions, or events, etc., prescribed for establishing *qualification* for relief under the statute—the change which was by far the most important was the

[52] Besides Section 722, relief under the World War II law was also granted, as we have seen, by the other two "abnormalities" provisions, namely, some parts of Section 711(b)(1) and Section 721. As to all three, a review of the Commissioner's determination was authorized only in the Tax Court, and, further, in the case of Section 722 and Section 721(a)(2)(C)—the antecedent of Section 456(a)(2)(B) directly involved here—by the Special Division of the Tax Court pursuant to Section 732(d). Any further review (in the appellate courts) was specifically prohibited by Section 732(c) of the Code. No comparable prohibition was contained in the Korean War law, and hence relief determinations under it are fully reviewable in the courts, to the same extent as determinations on other questions.

abandonment of the requirement of the prior law that a qualifying taxpayer must also establish "a fair and just amount representing normal earnings" (Section 722(a)), to be used as a "constructive average base period net income" (CABPNI) in all cases under the "general relief" provisions of Section 722. Congress concluded that the requirement under the former law of a hypothetical or constructive base period income (CABPNI), to be "tailor made" for each qualifying taxpayer, was too burdensome and difficult of proof,[53] and had been generally unsatisfactory in

[53] In referring to the problems in establishing a constructive average base period net income under Section 722, Congress observed, among other things (S. Rep. No. 2679, *supra*, p. 17 (1951-1 Cum. Bull., at p. 252)):

> Each case was a problem in research, and the legal or tax result generally was intertwined with complicated accounting and economic problems. Almost every factor which had any influence on the particular business was pertinent to the case and the time and expense involved in reconstructing the average base period earnings credit were tremendous.

See also, to the same effect, H. Rep. No. 3142, *supra*, p. 16 (1951-1 Cum. Bull., at p. 197).

The Sixth Circuit, declining to review in *Patent Button Co. of Tenn.* v. *Commissioner*, 256 F. 2d 726, stated with respect to the World War II relief provisions (p. 728):

> The concept that granting tax relief because of abnormal conditions requires expert judgment upon factors "not entirely susceptible of proof or disproof" and, so, negates the authority of a court to redetermine by review the judgment of an expert * * * has been recognized * * *.

Similarly, the Fourth Circuit in *St. [illegible]a Hosiery Mills* v. *Commissioner*, 249 F. 2d 469, stated (p. 471):

> The questions involved in such cases are complicated and highly technical; and the manifest purpose of Congress was to allow review of the Commissioner's action only by an administrative court having special competence in the premises.

practice. See H. Rep. No. 3142, *supra*, pp. 15–16 (1951–1 Cum. Bull., at p. 197); S. Rep. No. 2679, *supra*, pp. 17–18 (1951–1 Cum. Bull., at pp. 251–252). Congress therefore saw fit to substitute, in the Korean War law, a measure of relief based upon the automatic application of specific mathematical formulas. Thus, instead of the CABPNI of the former law, with all its complexities and discretionary factors, Congress adopted relief provisions in terms of specific formulae, measured with reference to the base period rates of return for the taxpayer's industry classification, which rates were to be determined and proclaimed by the Commissioner pursuant to Section 447 of the new law (Appendix, *infra*, pp. 19a–21a).[54]

As the result of that change in the basic concept governing the computation of the relief accorded to taxpayers establishing qualification or eligibility for relief—and, further, because of the adoption in the Korean War law of various other adjustments designed to alleviate the burden of the tax (see H. Rep. No. 3142, *supra*, at pp. 15–25 (1951–1 Cum. Bull., at pp. 197–204) and S. Rep. No. 2679, *supra*, pp. 17–29 (1951–1 Cum. Bull., at pp. 251–259))—Congress deemed it appropriate to modify or curtail the respective grounds for relief previously authorized under Section 722. For these same reasons, Congress also restricted the relief previously granted under Section

[54] In *Burford-Toothaker Tractor Co.* v. *United States*, 262 F. 2d 891, 892–893, the Fifth Circuit referred to "the metaphysical subjective imponderables in old Section 722 which Congress rejected as unworkable and unfair" when it prescribed an "automatic objective formula" for the Korean War law.

721 so as to eliminate the one phase which would have required the retention of the discretionary approach (see H. Rep. No. 3142, *supra,* p. 13 (1951–1 Cum. Bull., at p. 195); and S. Rep. No. 2679, *supra,* p. 13 (1951–1 Cum. Bull., at p. 249))—namely, that portion of Section 721(a)(2)(C) which had granted relief as to income "resulting from * * * research, or development of tangible property, patents, formulae, or processes * * *." In net effect, the various situations for which relief had been provided under Sections 721 and 722 of the prior law were either included within "automatic" relief provisions or they were eliminated.

Thus, the authorization for relief under Section 722(b)(1) with respect to decreased base period production or operation as the result of unusual or peculiar events found its way into a comparable provision in the Korean War law (Section 442(a)(1)). The relief formerly authorized in Section 722(b)(2) for the case of a taxpayer whose base period business was depressed by reason of temporary economic circumstances unusual in its experience was similarly authorized, with some limitation, by Section 442(a)(2).[55] The provisions which had authorized

[55] It may be noted that Section 722(b)(2) had also authorized relief where the business of the taxpayer during the base period was depressed because its industry was depressed by reason of temporary economic events unusual in that industry—which was eliminated as a ground for relief in the Korean War law because it was regarded as desirable to avoid the difficult questions of proof of depression in an industry as a whole, and because it was felt that hardship in such cases would be alleviated by other provisions being adopted in the Korean War law. H. Rep. No. 3142, *supra*, p. 17 (1951–1 Cum. Bull., at p. 198); S. Rep. No. 2679, *supra*, p. 19 (1951–1 Cum. Bull., at p. 252).

relief in the case of a taxpayer whose base period business was depressed as the result of either variant profit cycles or sporadic income (Section 722(b)(3)(A) and (B)) found their way into the provisions of Section 446 of the Korean War law, which granted a modified form of relief with respect to "depressed industry subgroups."

Subsection (b)(4) of Section 722 had provided relief for two classes of taxpayers, (1) those which commenced business and (2) those which changed the character of their business, either during or immediately prior to the base period. In the Korean War law, relief for the first class was provided by a separate provision (Section 445, Appendix, *infra*, p. 18a) which authorized the use by a "new corporation" (commencing business during or after the base period) of an alternative average base period net income computed upon the basis of the taxpayer's total assets and the base period rate of return for its industry classification (pursuant to Section 447).[56] Substantial and significant changes were made in the Korean War law with respect to the relief grounds authorized in the World War II law with respect to the second class, corporations which had undergone a change in the character of their business. In Section 722(b)(4), the term "change in the character of the business" had been defined as specifically including these categories: (a) "a change in the operation or management of the busi-

[56] The Korean War law provided a further measure of relief for new corporations by the reduced rates of tax authorized pursuant to Section 430(a)(3) and (e). (Appendix, *infra*, pp. 3a–4a).

ness"; (b) "a difference in the products or services furnished"; (c) "a difference in the capacity for production or operation"; (d) "a difference in the ratio of nonborrowed capital to total capital"; and (e) "the acquisition before January 1, 1940, of all or part of the assets of a competitor", eliminating or diminishing competition by that competitor. In the Korean War law, Congress deliberately eliminated as grounds for relief changes in management, changes in operation (*i.e.*, changes in *method* of operation), changes in the ratio of non-borrowed to total capital, and the acquisition of competitors; it regarded such grounds as either unimportant or insignificant, or unwarranted, or too difficult to apply. See H. Rep. No. 3142, *supra,* pp. 19–21 (1951–1 Cum. Bull., at pp. 199–201); S. Rep. No. 2679, *supra,* pp. 24–25 (1951–1 Cum. Bull., at pp. 256–257). Relief because of an increase in capacity was retained with some restrictions in Section 444 (Appendix, *infra,* p. 17a). Relief upon the basis of a "difference in the products or services furnished", which had existed under Section 722(b)(4) in the Second World War law, was again adopted as a ground for relief under the Korean War law (Section 443, Appendix, *infra,* pp. 14a–16a).

In Section 443 of the new law, Congress retained—but with new restrictions and limitations—the concept of the prior law that a change in products or services is an appropriate basis for relief, and specifically recognized that the experience under the World War II law with respect to that concept "was generally satisfactory". S. Rep. No. 2679, *supra,* p. 21 (1951–1 Cum. Bull., at p. 254). See also H. Rep. No. 3142,

supra, pp. 18–19, 54–55 (1951–1 Cum. Bull., at pp. 199–200, 225–226); H. Conference Rep. No. 3231, 81st Cong., 2d Sess., p. 21 (1951–1 Cum. Bull. 268, 274–275); and "Summary of * * * 'THE EXCESS PROFITS TAX ACT of 1950' as agreed to by the Conferees", prepared by the Staff of the Joint Committee on Internal Revenue Taxation (1951), pp. 13–14. The requirement of subsection (a)(1) that there be a "substantial change" in products or services does, it is true, leave room for a certain measure of discretion. However, qualification is largely governed by the requirements of subsections (a)(2) and (a)(3), respectively, that the new products or services account for over 40 per cent of gross income or 33 per cent of net income, and that there be an increase of more than 25 per cent in the excess profits net income. Furthermore, if qualification for relief is established by satisfying the qualifying tests of subsections (a)(1), (a)(2) and (a)(3), the amount of relief allowable is computed mathematically pursuant to subsection (b)(1) and (2), *i.e.*, by applying the base period rate of return for the taxpayer's industry classification under Section 447 to the taxpayer's total assets.

The benefits of all of these sections (Sections 442 through 446) were made available only upon application by the taxpayer pursuant to Section 447(e). And, in all cases under Sections 442 through 446, the amount of relief is computed by reference to specified mathematical formulae based upon the applicable industry base period rate of return proclaimed pursuant to Section 447.

The relief formerly allowable under Section 711(b)(1) (H), (I), (J), and (K), with respect to certain base period "abnormal" deductions, deductions attributable to a judgment or award, deductions attributable to intangible drilling costs, etc., for the purpose of the computation of the excess profits credit under the "income method," found its way (with some variations) into the Korean War law as an adjustment authorized to be made under Section 433(b)(9) (Appendix, *infra*, p. 7a) and (10).

Relief substantially similar to that formerly allowed as an automatic adjustment under the "75% rule" of Section 713(e) was again allowed in the Korean War law, though somewhat amplified and liberalized, under the provisions of Section 435(d) (Appendix, *infra*, pp. 9a–10a), permitting the elimination of the taxpayer's poorest base period year and the treatment of any deficit base period year as a "zero" year. See H. Rep. No. 3142, *supra*, p. 5 (1951–1 Cum. Bull., at p. 190). The other World War II automatic computation adjustment was by means of the so-called "growth formula" computation under Section 713(f). In the Korean War law, the "growth" concept was given some recognition in the provisions of Section 435(e) (Appendix, *infra*, pp. 10a–13a), which authorized an *alternative* average base period net income to be used in "growth" cases, but subject to greater restrictions and limitations—as, for example, the requirement contained in Section 435(e)(1)(B)(ii) that a minimum percentage of the taxpayer's sales be "attributable to a product, or class of products * * *, of a kind not generally available to the public" before the base period (*i.e.*, prior to 1946. See H. Rep. No. 3142, *supra*, pp. 23–

24 (1951-1 Cum. Bull., at p. 203), and S. Rep. No. 2679, *supra*, pp. 26–28 (1951-1 Cum. Bull., at pp. 251–259).

Viewing Section 435(e) together with Sections 443 and 444, it is apparent that by those provisions the Korean War law made available automatic relief adequate for manufacturers who, like the taxpayer here, experienced growth, introduced new products, or increased productive capacity during or shortly after the base period. Congress must have contemplated that manufacturers like this taxpayer look to the area of those provisions for their relief—and not to Section 456.

2. In Section 456(a)(2)(B) of the Korean War excess profits tax law, relief for income from the sale of products of "research" and "development," allowed under the prior law, was deliberately omitted and relief was provided only for income from "exploration, discovery, or prospecting" in the natural resources industries

As we have seen, *supra*, pp. 12–13, 16–17, 59–60, Section 456 of the 1950 Act was analogous to Section 721 of the World War II law, and similarly provided relief with respect to certain abnormal income received during the taxable year by permitting its reallocation to other years. But, in accordance with the changed concept of relief under the 1950 Act, the applicability of Section 456 was limited to four classes of income easily identified as to character and reasonably ascertainable as to amount. One of these classes—the one relied upon by the taxpayer here—is Section 456(a)(2)(B):

> (B) Income resulting from exploration, discovery, or prospecting, or any combination of

> the foregoing, extending over a period of more than 12 months * * *.

It was explained in both pertinent Committee Reports (H. Rep. No. 3142, 81st Cong., 2d Sess., p. 13 (1951–1 Cum. Bull. 187, 195); S. Rep. No. 2679, 81st Cong., 2d Sess., p. 14 (1951–1 Cum. Bull. 240, 249)) that:

> The equivalent provision in the World War II law (section 721) also permitted adjustments with reference to certain other types of income, particularly that resulting from the sale of tangible property arising out of research and development which extended over a period of more than 12 months.

However, in view of the automatic relief concept adopted in the 1950 Act, that additional feature of the old law—which was regarded (*ibid.*) as representing "a potential loophole of major dimensions"—was omitted from the classes of abnormal income for which relief was provided in the 1950 law.[57] The omission was made, it was explained (*ibid.*) "[b]ecause there appeared to be no means of restricting such an adjustment to truly meritorious cases other than by the introduction of a large degree of administrative discretion of the type required by the general relief clause of the World War II law (section 722) * * *". See *Polaroid Corp.* v. *Commissioner, supra,* 278 F. 2d at 155, where the First Circuit, discussing this legislative history, concluded: "Thus even 'meritorious cases' that would have come under this now excluded phrase ["research, or development

[57] See *Specialties, Inc.* v. *United States*, 174 F. Supp. 89, 93 (E.D. N.Y.), to the effect that the Committee Reports "both state in parallel language that this omission was intentional".

of tangible property"] were deliberately sacrificed in the interest of administrative simplification."[58]

In accordance with the concept of relief under the 1950 Act, the much broader class granted relief under the former Section 721(a)(2)(C) was confined by the new Section 456(a)(2)(B) so as to cover only income resulting from "exploration, discovery, or prospecting." Those terms, as we have seen, have long had an established meaning in the tax law limited to the natural resource industries, in which area the concept of "discovery value" had evolved (see Rev. Rul. 236, 1953–2 Cum. Bull. 236). Congress was aware, as observed above, that it had been found extremely difficult to ascertain what income was derived from "research" or "development" of tangible property, patents,[59] formulae or processes (see H. Rep. No. 3142, *supra*, p. 13 (1951–1 Cum. Bull. 187, 195); S. Rep. No. 2679, *supra*, p. 14 (1951–1 Cum. Bull. 240, 249)).

The taxpayer has urged (Br. in Op., pp. 6, 8) that, even though income of the type here involved has

[58] The loophole under the Second World War law was presumably regarded as "potential" rather than actual, because grants of relief under Section 721 for abnormal income resulting from the "research, or development of tangible property, patents, formulae, or processes" had been reasonably restricted in the litigated cases. See, *e.g.*, *Crowell-Collier Publishing Co.* v. *Commissioner*, 25 T.C. 1268, review dismissed on this point for lack of jurisdiction, 259 F. 2d 860 (C.A. 2d), certiorari denied, 358 U.S. 928; *L. E. Carpenter & Co.* v. *Commissioner*, 29 T.C. 562, review dismissed for lack of jurisdiction, 264 F. 2d 230 (C.A. 3d). See also the cases discussed *supra*, pp. 46–48. As we already have pointed out, because of Section 732(c) there was no appellate review of any question under the relief provisions of the Second World War law.

[59] See 10 Mertens, *Law of Federal Income Taxation* (Rev.), Sec. 59.38.

been excluded from the classes of income specifically listed in Section 456(a)(2), it is entitled to relief under the last sentence of Section 456(a)(2), which states:

> The classification of income of any class not described in subparagraphs (A) to (D), inclusive, shall be subject to regulations prescribed by the Secretary.

It is apparent, however, that this provision merely grants the Secretary authority to designate such additional classes of abnormal income as he may consider appropriate, acting, of course, consistently with the Congressional purpose expressed in Section 456. Any other conclusion would require the totally illogical result that all income which is received in amounts sufficient to satisfy the quantitative requirements of Section 456(a)(1) would be entitled to relief as "abnormal income" under Section 456. As already demonstrated, the classes of income treated as "abnormal" under Section 456(a)(2) were severely restricted because Congress decided to depart from the broader criteria of Section 721(a)(1) and (2) of the World War II statute. This restriction would have been an idle gesture if it were to be ruled that income of *any* class must be considered "abnormal" if it meets the quantitative test. See *Polaroid Corp.* v. *Commissioner, supra,* 278 F. 2d at 155–156.

Moreover, the Treasury has prescribed Regulations which specifically exclude income, such as this taxpayer's, derived from research and development. See Treasury Regulations 130, Section 40.456–2 (Appendix, *infra,* pp. 46a–47a). These Regulations further state,

to be sure, that Section 456 is applicable to income from research and development if the income is otherwise properly includible within a class of income listed in the section, for example, the class described in Section 456(a)(2)(D) (relating to income resulting from a change in accounting methods). That provision of the Regulations means only that *if* income arising from research and development *otherwise* qualifies as abnormal under a class listed in Section 456(a)(2), then the fact that it does arise from research and development will not disqualify such income from relief. To cite another example, if a taxpayer were awarded a judgment during the excess profits tax years (see Section 456(a)(2)(A)), even though the judgment was based on infringement with respect to products arising out of research and development, the income from the judgment could still qualify as "abnormal." However, the taxpayer's income in issue in this case is not "otherwise" within any of the classes granted relief under Section 456 (or the implementing Regulations).[80]

As in the case of prior excess profits tax laws, the Congressional hearings disclose that the representatives of the natural resources industries sought special

[80] Any suggestion that the products and income here involved could meet the "geophysical test"—on the theory that the taxpayer could show that "the important starting chemical of each drug is derived from coal tar or petroleum" (Br. in Op., p. 14)—is far wide of the mark. In order to meet the test the statute imposes, the taxpayer would have to establish that its alleged abnormal income was income resulting from a discovery of coal tar or petroleum, *i.e.*, a discovery of *deposits* of *coal* or *petroleum*.

treatment,[61] especially of the type granted formerly under Section 721. In particular, the American Mining Congress urged (House Hearings, Excess Profits Tax Act of 1950, p. 172) that:[62]

> The principle of section 721 should be continued with such revisions as may be needed to remove some of the complications and difficulties now encountered and to make it more directly and fully effective.

The representative of the same organization pointed out that in the case of a mine the profit potential is readily ascertainable and that reliable expert judgments may be utilized in the computation of excess profits.[63] See Rev. Rul. 236, 1953–2 Cum. Bull. 236.

The 1950 Act provided further substantial relief in recognition of the peculiar problems of the natural resources industries. In particular, the non-taxable income from the exempt excess output of taxpayers engaged in certain depletable resources industries (Section 453, Appendix, *infra,* pp. 21a–24a) was excluded from the computation of excess profits net income (Section 433(a)(1)(I)) (Appendix, *infra,* pp. 5a–

[61] See House Hearings, Excess Profits Tax Act of 1950, pp. 164–192; Senate Hearings, Excess Profits Tax Act of 1950, pp. 715–728, 777–781.

[62] See also House Hearings, *supra*, pp. 170–171.

[63] House Hearings, *supra*, pp. 169–170:

> The nature of the determinations required with respect to a reasonable normal profit per unit or reasonable normal expectancy is well understood by experienced mining engineers. They are continually making such determinations in their professional work. * * * Hence the adoption of such constructive determinations in connection with taxation is not going into a new and untried field. It is a part of the ordinary knowledge, experience, and training of mining engineers.

6a). The amount of the exempt excess output was computed under Section 453 on the basis of "estimated recoverable units" and "normal output" for particular mineral properties, since such estimates could be made with reasonable accuracy in the mining industries. See footnote 63, *supra*. Further, certain grants and loans made by the Federal Government and its agencies to encourage exploration, development or mining of critical and strategic minerals and metals were similarly excluded. Section 433(a)(1)(P) (Appendix, *infra*, p. 6a). Also, the portion of excess profits net income attributable to the mining of strategic minerals in the United States was wholly exempted from the excess profits tax. Section 450 (Appendix, *infra*, p. 21a).

Special treatment for natural resources industries was retained and expanded in the income tax sections of the Code in effect at the same time as the 1950 excess profits tax law.[64] The long-established provisions of Sections 105[65] and 114(b)(2),[66] for the relief of taxpayers having income derived from the discovery values of natural resources, were continued. In addition, Section 23(ff)—added by Section 342(a), Revenue Act of 1951, c. 521, 65 Stat. 452—permitted the deduction from net income of certain "exploration expenditures", including:

---

[64] Contrast the relief for income of individuals and partnerships, but not corporations, derived from inventions, provided by Section 107(b) of the Code.

[65] Limiting the tax on income from the sale of oil or gas properties or interests "where the principal value of the property has been demonstrated by prospecting or exploration or discovery work done by the taxpayer * * *".

[66] Providing for depletion on the basis of discovery value in the case of certain mines.

> In the case of expenditures paid or incurred during the taxable year for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral, and paid or incurred prior to the beginning of the development stage of the mine or deposit, so much of such expenditures as does not exceed $75,000. * * *

The concepts of "exploration" and "discovery" appear in Section 23(ff)(2) in connection with the option given to taxpayers to defer such expenses and deduct them ratably "as the units of produced ores or minerals discovered or explored by reason of such expenditures are sold".

The related portions of the Code, as well as the Congressional Hearings and Committee Reports discussed *supra,* demonstrate conclusively, we believe, that the provision of Section 456(a)(2)(B) granting relief for income resulting from "exploration, discovery, or prospecting" constitutes a part of the general scheme of income tax and excess profits tax relief for the natural resources industries and that the application of Section 456(a)(2)(B) is confined to these industries.[67]

The omission of the phrase "research, or development of tangible property, patents, formulae, or proc-

---

[67] We do not discuss the wisdom of the "statutory policy", the sole problem here being the "application of the congressional mandate." Cf. *United States* v. *Cannelton Sewer Pipe Co.*, 364 U.S. 76, 81.

It may be noted in passing that the Court there (p. 81) referred to "mineral depletion for tax purposes" as an allowance to encourage "extensive *exploration* and increasing *discoveries* of additional minerals." (Emphasis supplied.)

esses" from Section 456(a)(2)(B) must be evaluated in the light of the history of the excess profits tax, particularly the relief provisions dealing with the natural resources industries and the gradual progression from discretionary relief administered by the Commissioner, to relief in his discretion but with review by the Tax Court, to automatic and readily ascertainable relief under the formulae of the Korean War law. Considered against the background of the discretionary relief provisions of prior excess profits tax statutes and the difficult problems encountered thereunder, the Congressional explanation of the omission of the "research" and "development" clause of the prior law leaves no doubt but that Section 456(a)(2)(B) was intended to provide relief *only* for the natural resources industries and that income from sales of products of research and development, such as the taxpayer's drugs, was deliberately excluded from relief under Section 456. When read in this light, the pertinent legislative explanation acquires, we submit, compelling force (H. Rep. No. 3142, 81st Cong., 2d Sess., p. 13 (1951–1 Cum. Bull. 187, 195); S. Rep. No. 2679, 81st Cong., 2d Sess., p. 13 (1951–1 Cum. Bull. 240, 249)):

> The bill contains a provision allowing the correction of the net income of the excess profits tax years for other abnormalities. This provision is similar to section 721 of the World War II law. Generally, income appearing in particular excess profits tax years is reallocated under this provision if it is attributable to events that occurred or work that was done in other years. Such an adjustment is made only

if the income of the class deemed to be abnormal received in the taxable year is more than 115 percent of the average amount of the income of the same class received during the four previous taxable years. In appropriate cases such an excess will be attributed to other years under regulations to be prescribed by the Secretary of the Treasury.

Adjustments of this type are limited to income arising out of—

1. A claim, award, adjustment, or decree;

2. Exploration, discovery, or prospecting which extended over a period of more than 12 months;

3. The sale of patents, formulas, or processes developed over a period of more than 12 months; or

4. Income which is includible in the taxable year rather than another year by reason of a change in the taxpayer's method of accounting.

The equivalent provision in the World War II law (section 721) also permitted adjustments with reference to certain other types of income, particularly that resulting from the sale of tangible property arising out of research and development which extended over a period of more than 12 months. This provision in the old law was a potential loophole of major dimensions. Because there appeared to be no means of restricting such an adjustment to truly meritorious cases other than by the introduction of a large degree of administrative discretion of the type required by the general relief clause of the World War II law (section 722), and because the need for a reallocation of such income seemed to be materially less

than in the other classes of income described above, this item has been omitted from the list of abnormal types of income for which a reallocation can be made under this bill.

CONCLUSION

For the reasons stated, the judgment of the Court of Appeals should be reversed, with directions to reinstate the judgment of the District Court dismissing the complaint.

Respectfully submitted.

J. LEE RANKIN,
Solicitor General.
ABBOTT M. SELLERS,
Acting Assistant Attorney General.
HARRY MARSELLI,
NORMAN H. WOLFE,
Attorneys.

JANUARY 1961.

APPENDIX

Internal Revenue Code of 1939:

CHAPTER 1—INCOME TAX

* * * * *

SUBCHAPTER C—SUPPLEMENTAL PROVISIONS

* * * * *

SEC. 105. SALE OF OIL OR GAS PROPERTIES.

In the case of a bona fide sale of any oil or gas property, or any interest therein, where the principal value of the property has been demonstrated by prospecting or exploration or discovery work done by the taxpayer, the portion of the tax imposed by section 12 attributable to such sale shall not exceed 30 per centum of the selling price of such property or interest.

(26 U.S.C. 1952 ed., Sec. 105.)

SEC. 114 [as amended by Sec. 319(b), Revenue Act of 1951, c. 521, 65 Stat. 452]. BASIS FOR DEPRECIATION AND DEPLETION.

* * * * *

(b) *Basis for Depletion.*—

* * * * *

(2) *Discovery value in the case of mines.*—In the case of mines (except mines in respect of which percentage depletion is allowable under paragraph (4) of this subsection), discovered by the taxpayer after February 28, 1913, the basis for depletion shall be the fair market value of the property at the date of discovery or within thirty days thereafter, if such mines were not acquired as the result of

purchase of a proven tract or lease, and if the fair market value of the property is materially disproportionate to the cost. The depletion allowance under section 23(m) based on discovery value provided in this paragraph shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property upon which the discovery was made, except that in no case shall the depletion allowance under section 23(m) be less than it would be if computed without reference to discovery value. Discoveries shall include minerals in commercial quantities contained within a vein or deposit discovered in an existing mine or mining tract by the taxpayer after February 28, 1913, if the vein or deposit thus discovered was not merely the uninterrupted extension of a continuing commercial vein or deposit already known to exist and if the discovered minerals are of sufficient value and quantity that they could separately mined and marketed at a profit.

* * * * *

(26 U.S.C. 1952 ed., Sec. 114.)

* * * * *

SUBCHAPTER D—EXCESS PROFITS TAX

[As added by Sec. 101, Excess Profits Tax Act of 1950, c. 1199, 64 Stat. 1137, Section 101.]

SEC. 430. IMPOSITION OF TAX.

(a) [as amended by Sec. 501(1), Revenue Act of 1951, *supra,* and the Act of July 16, 1953, c. 202, 67 Stat. 175] *General Rule.*—In addition to other taxes imposed by this chapter, there shall be levied, collected, and paid for each taxable year ending after June 30, 1950, and beginning before January 1, 1954, upon the adjusted excess profits net income, as defined in section 431, of every corporation (except a corporation exempt under section 454) an excess

profits tax equal to whichever of the following amounts is the lesser:

(1) 30 per centum of the adjusted excess profits net income, or

* * * * *

(3) in the case of a corporation for which an amount is determined for the taxable year under subsection (e), the amount determined under such subsection.

* * * * *

(e) [as added by Sec. 501(3), Revenue Act of 1951, *supra*] *New Corporations.*—

(1) *Alternative amount.*—In the case of a taxpayer which commenced business after July 1, 1945, and whose fifth taxable year ends after June 30, 1950, the amount referred to in subsection (a)(3) shall be—

(A) If the taxable year is the first or second taxable year of the taxpayer, an amount equal to 5 per centum of the excess profits net income for the taxable year, except that if the excess profits net income exceeds $300,000, the amount shall be the sum of $15,000 plus the amount determined under subparagraph (E) of this paragraph.

(B) If the taxable year is the third taxable year of the taxpayer, an amount equal to 8 per centum of the excess profits net income for the taxable year, except that if the excess profits net income exceeds $300,000, the amount shall be the sum of $24,000 plus the amount determined under subparagraph (E) of this paragraph.

(C) If the taxable year is the fourth taxable year of the taxpayer, an amount equal to 11 per centum of the excess profits net income for the taxable year, except that if the excess profits net income exceeds $300,000, the amount shall be the sum of

$33,000 plus the amount determined under subparagraph (E) of this paragraph.

(D) If the taxable year is the fifth taxable year of the taxpayer, an amount equal to 14 per centum of the excess profits net income for the taxable year, except that if the excess profits net income exceeds $300,000, the amount shall be the sum of $42,000 plus the amount determined under subparagraph (E) of this paragraph.

(E) The amount determined under this subparagraph shall be—

(i) if the taxable year ends before April 1, 1951, an amount equal to 15 per centum of the excess profits net income for the taxable year over $300,000.

(ii) if the taxable year begins on January 1, 1951, and ends on December 31, 1951, an amount equal to 17¼ per centum of the excess of the excess profits net income for the taxable year over $300,000.

(iii) if the taxable year (other than a taxable year described in clause (ii)) ends after March 31, 1951, an amount equal to 18 per centum of the excess of the excess profits net income for the taxable year over $300,000.

* * * * *

(f) [As amended by Sec. 501(2), Revenue Act of 1951, *supra*] *Cross References.*—For special rules for computation of the tax imposed by subsection (a) in the case of—

* * * * *

(2) corporations engaged in mining of strategic materials, see section 450(a);

(3) abnormalities in income in taxable period, see section 456;

* * * * *

(26 U.S.C. 1952 ed., Sec. 430.)

SEC. 431. DEFINITION OF ADJUSTED EXCESS PROFITS NET INCOME.

The term "adjusted excess profits net income" in the case of any taxable year means the excess profits net income (as defined in section 433(a)) minus the sum of:

(1) *Excess profits credit.*—The amount of the excess profits credit allowed under section 434; and

(2) *Unused excess profits credits.*—The amount of the unused excess profits credit adjustment for the taxable year computed in accordance with section 432.

If such sum is less than $25,000, it shall be increased to $25,000.

(26 U.S.C. 1952 ed., Sec. 431.)

SEC. 433. EXCESS PROFITS NET INCOME.

(a) *Taxable Years Ending After June 30, 1950.*—The excess profits net income for any taxable year ending after June 30, 1950, shall be the normal-tax net income, as defined in section 13(a)(2), for such year increased or decreased by the following adjustments:

(1) *Adjustments.*—

* * * * *

(I) *Nontaxable income of certain industries with depletable resources.*—In the case of a producer of minerals, or a producer of logs or lumber from a timber block, or a lessor of mineral property, or a timber block, as defined in section 453, there shall be excluded nontaxable income from exempt excess output of mines and timber blocks provided in section 453; in the case of a natural gas company, as defined in section 453, there shall be excluded nontaxable income from exempt excess output provided in section 453; and in the case of a producer of minerals, or a producer of logs or lumber from a timber

block, there shall be excluded nontaxable bonus income provided in section 453. In respect of nontaxable bonus income provided in section 453(c), a corporation described in section 453(c)(2) shall be deemed a producer of minerals for the purposes of this subparagraph;

* * * * *

(P) *Payments to encourage exploration, development, and mining for defense purposes.*—An amount paid to a taxpayer by the United States (or any agency or instrumentality thereof), whether by grant or loan, and whether or not repayable, for the encouragement of exploration, development or mining of critical and strategic minerals or metals pursuant to or in connection with any undertaking approved by the United States (or any of its agencies or instrumentalities) and for which an accounting is made or required to be made to an appropriate governmental agency, and the forgiveness or discharge of any of such amount shall be excluded in computing excess profits net income; and any expenditures (other than expenditures made after the repayment of such grant or loan) attributable to such grant or loan shall not be deductible by the taxpayer as an expense nor increase the basis of the taxpayer's property either for determining gain or loss on sale, exchange, or other disposition or for computing depletion or depreciation, but upon the repayment of any portion of any such grant or loan which has been expended in accordance with the terms thereof such deductions and such increase in basis shall to the extent of such repayment be allowed as if made at the time of such repayment;

* * * * *

(b) *Taxable Years in Base Period.*—For the purposes of computing the average base period net income, the excess profits net income for any taxable year shall be the normal-tax net income, as defined in section 13(a)(2) as in effect for such taxable year, increased or decreased by the following adjustments:

* * * * *

(9) *Judgments, intangible drilling and development costs, casualty losses, and other abnormal deductions.*—If, for any taxable year or years within, or beginning or ending within, the base period, any class of deductions for the taxable year exceeded 115 per centum of the average amount of deductions of such class for the four previous taxable years (not including deductions arising from the same extraordinary event which gave rise to the deduction for the taxable year), the deductions of such class shall, subject to the rules provided in paragraph (10), be disallowed in an amount equal to such excess. For the purposes of this paragraph, each of the following groups of deductions shall constitute a class of deductions:

(A) Deductions attributable to claims, awards, judgments, and decrees against the taxpayer, and interest on the foregoing;

(B) Deductions attributable to intangible drilling and development costs paid or incurred in or for the drilling of wells or the preparation of wells for the production of oil or gas, and for development costs in the case of mines; and

(C) Deductions under section 23(f) for losses arising from fires, storms, * * *

The classification of deductions of any class not described in subparagraphs (A) to (C), inclusive, shall be subject to regulations prescribed by the Secretary.

* * * * *

(26 U.S.C. 1952 ed., Sec. 433.)

SEC. 434. EXCESS PROFITS CREDIT—ALLOWANCE.

(a) *Domestic Corporations.*—In the case of a domestic corporation, the excess profits credit for any taxable year shall be an amount computed under section 435 or section 436, whichever amount results in the lesser tax under this subchapter for the taxable year for which the tax under this subchapter is being computed.

* * * * * *

(26 U.S.C. 1952 ed., Sec. 434.)

SEC. 435. EXCESS PROFITS CREDIT—BASED ON INCOME.

(a) [as amended by Sec. 602(a)(1), Revenue Act of 1951, *supra*] *Amount of Excess Profits Credit.*—The excess profits credit for any taxable year, computed under this section, shall be—

(1) *Domestic corporations.*—In the case of a domestic corporation the sum of—

(A) 83 per centum of the average base period net income,

(B) if the average base period net income of the taxpayer is the amount determined under subsection (d) of this section or under section 442, 12 per centum of the amount of the base period capital addition, computed under subsection (f), and

(C) 12 per centum of the net capital addition (as defined in subsection (g)(1)) for the taxable year, minus 12 per centum of the net capital reduction (as defined in subsection (g)(2)) for the taxable year.

* * * * * *

(b) *Base Period.*—As used in this subchapter the term "base period" means the period beginning January 1, 1946, and ending December 31, 1949, except that in the case of a taxpayer whose first taxable year under this subchapter was preceded by a taxable year which ended after December 31, 1949, and be-

fore April 1, 1950, and which began before January 1, 1950, the term "base period" means the period of 48 consecutive months ending with the close of such preceding taxable year.

(c) [as amended by Sec. 516(b), Revenue Act of 1951, *supra*] *Average Base Period Net Income—Determination.*—For the purposes of this section the average base period net income of the taxpayer shall be the amount determined under subsection (d), subject to the exception that if the taxpayer is entitled to the benefits of subsection (e) of this section, or section 442, 443, 444, 445 or 446, or any subsection of section 459, then the average base period net income shall be the amount determined under subsection (d) or (e) or under such section or subsection, whichever results in the lesser tax under this subchapter for the taxable year for which the tax under this subchapter is being computed.

(d) [as amended by Sec. 503, Revenue Act of 1951, *supra*] *Average Base Period Net Income—General Average.*—The average base period net income determined under this subsection shall be determined as follows:

(1) By computing the excess profits net income for each month in the base period. * * *

(2) By eliminating from the base period whichever of the following twelve months results in the higher average base period net income—

* * * * *

(3) By computing the aggregate of the excess profits net income for each of the thirty-six months remaining in the base period.

(4) By dividing by 3 the amount ascertained under paragraph (3).

For the purpose of the computations under this subsection in the case of a taxpayer whose

first taxable year under this subchapter is a taxable year which either began before January 1, 1950, or was preceded by a taxable year beginning before January 1, 1950, and ending after March 31, 1950, there shall be substituted for the base period of the taxpayer the period of 48 consecutive months ending March 31, 1950, if such substitution produces a lesser tax under this subchapter for the taxable year for which the tax is being computed. In computing the average base period net income for such substituted period, the excess profits net income for January, February, and March of 1950 shall be computed by use of the "weighted excess profits net income", as defined in section 435(e)(2)(E), for the taxable year in which such months fall.

(e) *Average Base Period Net Income—Alternative Based on Growth.*—

(1) [as amended by Sec. 504(a), Revenue Act of 1951, *supra*] *Taxpayers to which subsection applies.*—A taxpayer shall be entitled to the benefits of this subsection if the taxpayer commenced business before the end of its base period, and if either—

(A) (i) the total assets of the taxpayer as of the first day of its base period (when added to the total assets for such day of all corporations with which the taxpayer has the privilege under section 141 of filing a consolidated return for its first taxable year under this subchapter), determined under paragraph (3), did not exceed $20,000,000, and

(ii) The total payroll of the taxpayer (as determined under paragraph (4)) for the last half of its base period is 130 per centum or more of its total payroll for the first half of its base period, or the gross receipts of the taxpayer (as determined under paragraph (5)) for the last

half of its base period is 150 per centum or more of its gross receipts for the first half of its base period; or

(B)(i) the taxpayer's net sales for the period beginning January 1, 1950, and ending June 30, 1950, when multiplied by 2, equals or exceeds 150 per centum of its average net sales for the calendar years 1946–1947; and

(ii) 40 per centum or more of the taxpayer's net sales for the calendar year 1950 is attributable to a product, or class of products (including any article in which such product or class of products is the principal component and including any article which is a component of such product or class of products), of a kind not generally available to the public at any time prior to January 1, 1946, and

(iii) the amount of the taxpayer's net sales which is attributable to such product or class of similar products, for the calendar year 1946 is 5 per centum or less of the amount of its net sales so attributable for the calendar year 1949. For the purposes of this subparagraph, the term "net sales" with respect to any period means the total amount received or accrued during such period from the sale, exchange, or other disposition of stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business; reduced by the amount of discounts, returns, and allowances paid or incurred for such period.

(2) [as amended by Sec. 505, Revenue Act of 1951, *supra*] *Computation.*—The aver-

age base period net income determined under this subsection shall be determined as follows:

(A) By computing (in the manner provided by the second sentence of subsection (d)(1)) the excess profits net income for each of the last 24 months in the base period.

(B) By computing the aggregate of the excess profits net income for each such month.

(C) By dividing by 2 the amount ascertained under subparagraph (B).

(D) By computing the aggregate of the excess profits net income for each of the last twelve months in the base period.

(E) By computing (in the manner provided by the second sentence of subsection (d)(1)) the excess profits net income for each of the twelve months in the period beginning July 1, 1949, and ending June 30, 1950. * * *

(F) By computing the aggregate of the excess profits net income for each of the twelve months referred to in subparagraph (E).

(G) In the case of a taxpayer who is entitled to the benefits of this subsection under paragraph (1)(B) and whose excess profits net income for the calendar year 1949 is not more than 25 per centum of its excess profits net income for the calendar year 1948, by computing—

(i) in the manner provided by subparagraph (E), the excess profits net income for each of the six months in the period beginning July 1, 1948, and ending December 31, 1948, and for each of the six months in the period beginning January 1, 1950, and [ending] June 30, 1950, and

(ii) the aggregate of the excess profits net income for each of the twelve months referred to in clause (i).

The average base period net income determined under this subsection shall be the amount ascertained under subparagraph (C), (D), or (F), whichever is the highest, except that in the case of a taxpayer described in subparagraph (G), its average base period net income determined under this subsection shall be the amount ascertained under subparagraph (C), (D), (F), or (G)(ii), whichever is the highest.

* * * * * *

(26 U.S.C. 1952 ed., Sec. 435.)

SEC. 442. AVERAGE BASE PERIOD NET INCOME—ABNORMALTIES DURING BASE PERIOD.

(a) [as amended by Sec. 509(a)(1), Revenue Act of 1951, *supra*] *In General.*—If a taxpayer which commenced business on or before the first day of its base period establishes that, for any taxable year within, or beginning or ending within, its base period:

(1) normal production, output, or operation was interrupted or diminished because of the occurrence, either immediately prior to, or during such taxable year, of events unusual and peculiar in the experience of such taxpayer, or

(2) the business of the taxpayer was depressed because of temporary economic circumstances unusual in the case of such taxpayer:

the taxpayer's average base period net income determined under this section shall be the amount computed under subsection (c) or (d), whichever is applicable. If such taxpayer is also entitled to the benefits of subsection (h), the taxpayer's average base period net income determined under this section shall be the amount computed under subsection (c) or (d),

whichever is applicable to the taxpayer, or the amount computed under subsection (h), whichever results in the lesser tax under this subchapter for the taxable year. In the case of any other taxpayer entitled to the benefits of subsection (h), the taxpayer's average base period net income determined under this section shall be the amount computed under subsection (h).

* * * * * *

(26 U.S.C. 1952 ed., Sec. 442.)

SEC. 443. AVERAGE BASE PERIOD NET INCOME—CHANGE IN PRODUCTS OR SERVICES.

(a) *In General.*—If a taxpayer which commenced business on or before the first day of its base period establishes with respect to any taxable year that—

(1) During so much of its three immediately preceding taxable years as falls within the 36-month period ending on the last day of its base period, there was a substantial change in the products or services furnished by the taxpayer.

(2) More than 40 per centum of its gross income or 33 per centum of its net income for such taxable year is attributable to one or more of the new products or services, and

(3) Its average monthly excess profits net income (determined under subsection (e)) for such taxable year exceeds 125 per centum of its average monthly excess profits net income (determined under subsection (e)) for the taxable years ending within its base period and prior to the taxable year in which the first change to which gross income is attributed for the purpose of this subsection occurred,

then, in computing its excess profits credit for taxable years under this subchapter which end on or after the last day of the earliest taxable

year with respect to which the requirements of paragraphs (1), (2), and (3) are satisfied, its average base period net income determined under this section shall be the amount computed under subsection (b).

(b) *Average Base Period Net Income.*—The average base period net income determined under this section shall be computed as follows:

(1) By multiplying the amount of the taxpayer's total assets for (A) the last day of its taxable year immediately preceding its first taxable year under this subchapter, or (B) the last day of the taxable year in which the taxpayer first meets the requirements of subsection (a), whichever day is later, by the base period rate of return, proclaimed by the Secretary under section 447, for the taxpayer's industry classification.

(2) By subtracting from the amount ascertained under paragraph (1) the total interest paid or incurred by the taxpayer for the 12 months ending with whichever day is used under such paragraph.

(c) *Taxpayer's Industry Classification.*—For the purposes of this section, the taxpayer's industry classification shall be the industry classification under section 447 to which is attributable the largest amount of the taxpayer's gross receipts for the taxable year which includes whichever day is used under subsection (b).

* * * * *

(e) *Average Monthly Excess Profits Net Income.*—For the purposes of subsection (a)(3)—

(1) The excess profits net income for any year shall be computed by making the adjustments provided in section 433(b) as though such section were applicable to all taxable years.

(2) The average monthly excess profits net income for any period of two or more taxable

years shall be determined (A) by computing the aggregate of the excess profits net income for all taxable years within such period, (B) by subtracting from such aggregate the aggregate amount of the deficits in excess profits net income for all taxable years within such period, and (C) by dividing the amount ascertained under (B) by the total number of months in such taxable years.

(3) The average monthly excess profits net income determined for any period shall in no case be less than zero.

(f) [as amended by Sec. 511, Revenue Act of 1951, *supra*] *Rules for Application of Section.*—

(1) The benefits of this section shall not be allowed unless the taxpayer makes application therefor in accordance with section 447(e).

(2) If after the end of the base period of the taxpayer there was a substantial change in the products produced by the taxpayer, such change shall, for the purpose of subsection (a)(1), be considered to have occurred on the last day of its base period if the taxpayer prior to July 1, 1950, commenced the construction of the facilities for the production of such new product, and if such construction and the production of such new product is in furtherance of a course of action to which the taxpayer (or a corporation with which the taxpayer has the privilege under section 141 of filing a consolidated return for its first taxable year under this subchapter) was committed prior to the close of the base period by contract with another person, which contract granted a license, franchise, or similar right essential for the production of such new product.

* * * * *

(26 U.S.C. 1952 ed., Sec. 443.)

SEC. 444 [as amended by Sec. 520, Revenue Act of 1951, *supra*] AVERAGE BASE PERIOD NET INCOME—INCREASE IN CAPACITY FOR PRODUCTION OR OPERATION.

(a) *In General.*—If a taxpayer which commenced business on or before the first day of its base period establishes that, during the 36-month period ending on the last day of its base period, there was an increase, as defined in subsection (b), in its capacity for production or operation, the taxpayer's average base period net income determined under this section shall be the amount computed under subsection (c).

* * * * *

(c) *Average Base Period Net Income.*—The average base period net income determined under this section shall be computed as follows:

(1) By multiplying the amount of the taxpayer's total assets for the last day of its taxable year immediately preceding its first taxable year under this subchapter by the base period rate of return, proclaimed by the Secretary under section 447, for the taxpayer's industry.

(2) By subtracting from the amount ascertained under paragraph (1) an amount equal to the total interest paid or incurred by the taxpayer for the 12 months ending with the end of such immediately preceding taxable year.

* * * * *

(f) *Rules for Application of Section.*—

(1) The benefits of this section shall not be allowed unless the taxpayer makes application therefor in accordance with section 447(e).

* * * * *

(26 U.S.C. 1952 ed., Sec. 444.)

SEC. 445. AVERAGE BASE PERIOD NET INCOME—NEW CORPORATION.

(a) *New Corporation.*—A taxpayer which commenced business after the first day of its base period shall, except as provided in subsection (g), be considered a new corporation for the purposes of this section, and its average base period net income determined under this section shall be the amount computed under subsection (b).

(b) *Average Base Period Net Income.*—The average base period net income of a new corporation determined under this section shall be computed as follows:

(1) For the purpose of determining the excess profits credit for any of the taxpayer's first three taxable years which is a taxable year under this subchapter—

(A) By multiplying the amount of the total assets for such taxable year (determined under subsection (c)), held by the taxpayer in good faith for the purposes of the business, by the base period rate of return, proclaimed by the Secretary under section 447, for the taxpayer's industry classification.

(B) By subtracting from the amount ascertained under subparagraph (A) the total interest paid or incurred by the taxpayer for the 12 months ending with the last day of such taxable year.

* * * * *

(26 U.S.C. 1952 ed., Sec. 445.)

SEC. 446. AVERAGE BASE PERIOD NET INCOME—DEPRESSED INDUSTRY SUBGROUPS.

(a) *In General.*—If a taxpayer which commenced business or or before the first day of its base period is a member of a depressed industry subgroup, as defined in subsection (c), its average base period net income determined

under this section shall be the amount computed under subsection (b).

(b) *Average Base Period Net Income.*—The average base period net income determined under this section shall be computed as follows:

(1) By determining the amount of the taxpayer's total assets for the last day of each of its taxable years ending after the first day of its base period and prior to the first day of its first taxable year under this subchapter.

(2) By computing the average of the amounts ascertained under paragraph (1).

(3) By multiplying the amount ascertained under paragraph (2) by the adjusted rate of return, proclaimed by the Secretary under subsection (e), for the taxpayer's industry subgroup.

* * * * *

(c) *Depressed Industry Subgroups.*—The Secretary shall determine and proclaim as a depressed industry subgroup any industry subgroup (defined in accordance with subsection (f)) having a rate of return (determined under subsection (d)(1)) for the period 1946 through 1948 which is less than 63 per centum of its rate of return (determined under subsection (d)(2)) for the period 1938 through 1948.

* * * * *

(26 U.S.C. 1952 ed., Sec. 446.)

SEC. 447. INDUSTRY BASE PERIOD RATES OF RETURN.

(a) *Base Period Yearly Rate of Return.*—The Secretary shall determine and proclaim for each industry classification in subsection (c) a rate of return (computed to the nearest thousandth) for each of the four years 1946 through 1949. The yearly rate of return for each industry classification shall be obtained by dividing the sum of the aggregate net income (computed without regard to the net operating loss deduction provided in section 23(s)) and

the aggregate interest deduction shown on the income tax returns filed by the corporations in such classification submitting balance sheets, by the aggregate total assets of such corporations as of the close of the taxable year for which such returns were filed. Such aggregate net income, interest deduction and total assets for each such year shall include the amounts reported on the income tax returns for the calendar year and the amounts reported on returns for other taxable years the greater part of which falls in such calendar year. The determinations by the Secretary required under this section shall be made on the basis of returns regularly used by the Treasury Department in compiling published statistics from income tax returns, computing all rates of return after giving effect to renegotiation of contracts in accordance with renegotiation statistics published in the statistics compiled with respect to industry classifications.

(b) *Base Period Rate of Return.*—The Secretary shall determine and proclaim for each industry classification in subsection (c) a rate of return (computed to the nearest thousandth) for the four year period 1946 through 1949. Such base period rate of return for each industry classification shall be obtained by aggregating the net income and interest deduction (such amounts being determined as provided under subsection (a)) for such four years and dividing the aggregate by the sum of the total assets (determined as provided under subsection (a)) for such four years.

(c) *Industry Classification.*—For purposes of this subchapter the classification of taxpayers by industry shall be as provided in the table below. Each such industry classification is defined in accordance with the specifications shown in the Standard Industrial Classification Manual (prepared by the Division of Statistical Standards, Bureau of the

Budget) for the major industry group or groups the numbers of which appear opposite such classification.

* * * * *

(26 U.S.C. 1952 ed., Sec. 447.)

SEC. 450. CORPORATIONS ENGAGED IN MINING OF STRATEGIC MINERALS.

(a) *Exemption From Tax.*—In the case of any domestic corporation engaged in the mining of a strategic mineral, the portion of the adjusted excess profits net income attributable to such mining in the United States shall be exempt from the tax imposed by this subchapter. The tax on the remaining portion of such adjusted excess profits net income shall be an amount which bears the same ratio to the tax computed without regard to this section as such remaining portion bears to the entire adjusted excess profits net income.

(b) [as amended by Sec. 522, Revenue Act of 1951, *supra*] *Definitions.*—For the purposes of this section—

(1) the term "strategic mineral" means antimony, chromite, bauxite, manganese * * * and any other mineral which the certifying agency has certified to the Secretary as being essential to the defense effort of the United States and as not having been normally produced in appreciable quantities within the United States.

* * * * *

(26 U.S.C. 1952 ed., Sec. 450.)

SEC. 453. NONTAXABLE INCOME FROM CERTAIN MINING AND TIMBER OPERATIONS, AND FROM NATURAL GAS PROPERTIES.

(a) *Definitions.*—For the purposes of this section and section 433(a)—

(1) *Producer; lessor; natural gas company.*—The term "producer" means a corporation which extracts minerals from a min-

eral property, or which cuts logs from a timber block, in which an economic interest is owned by such corporation. The term "lessor" means a corporation which owns an economic interest in a mineral property or a timber block, and is paid in accordance with the number of mineral units or timber units recovered therefrom by the person to which such property or block is leased. The term "natural gas company" means a corporation engaged in the withdrawal, or transportation by pipe line, of natural gas.

(2) *Mineral unit; natural gas unit; and timber unit.*—The term "mineral unit" means a unit of metal, coal, or nonmetallic substance in the minerals recovered from the operation of a mineral property. The term "natural gas unit" means a unit of natural gas sold by a natural gas company. The term "timber unit" means a unit of timber recovered from the operation of a timber block.

(3) *Excess output.*—The term "excess output" means the excess of the mineral units, natural gas units, or timber units for the taxable year over the normal output.

(4) *Normal output.*—The term "normal output" means the average annual mineral units, or the average annual timber units, as the case may be, recovered in the taxable years beginning after December 31, 1945, and not ending after June 30, 1950 (hereinafter in this section called "normal period"), of the person owning the mineral property or the timber block (whether or not the taxpayer). The term "normal output", in the case of a natural gas company, means the average annual natural gas units sold in the taxable years beginning after December 31, 1945, and not ending after June 30, 1950, (hereinafter in this section called "normal period"), of the person owning the natural

gas property (whether or not the taxpayer). The average annual mineral units, natural gas units, or timber units shall be computed by dividing the aggregate of such mineral units, natural gas units, or timber units for the normal period by the number of months for which the mineral property, natural gas property, or timber block was in operation during the normal period and by multiplying the amount so ascertained by twelve. * * *

(5) *Natural gas property.*—The term "natural gas property" means the property of a natural gas company used for the withdrawal, storage, and transportation by pipe line, of natural gas, excluding any part of such property which is an emergency facility under section 124A.

(6) *Mineral property.*—The term "mineral property" means a mineral deposit, the development and plant necessary for the extraction of the deposit, and so much of the surface of the land as is necessary for purposes of such extraction.

(7) *Minerals.*—The term "minerals" means ore of the metals, coal, and such nonmetallic substances as abrasives, asbestos, asphaltum * * *.

* * * * *

(11) *Estimated recoverable units.*—The term "estimated recoverable units" means the estimated number of units of metal, coal, or nonmetallic substances in the estimated recoverable minerals from the mineral property at the end of the taxable year plus the excess output for such year. All estimates shall be subject to the approval of the Secretary, the determinations of whom for the purposes of this section, shall be final and conclusive.

(12) *Exempt excess output.*—The term "exempt excess output" for any taxable year means a number of units equal to the follow-

ing percentages of the excess output for such year:

* * * * *

(b) *Nontaxable Income From Exempt Excess Output.*—

(1) *General rule.*—For any taxable year for which the excess output of mineral property which was in operation during the normal period exceeds 5 per centum of the estimated recoverable units from such property, the nontaxable income from exempt excess output for such year shall be an amount equal to the exempt excess output for such year multiplied by the normal unit profit, but such amount shall not exceed the net income (computed with the allowance for depletion) attributable to the excess output for such year.

* * * * *

(26 U.S.C. 1952 ed., Sec. 453.)

SEC. 456. ABNORMALITIES IN INCOME IN TAXABLE PERIOD.

(a) *Definitions.*—For the purposes of this section—

(1) *Abnormal income.*—The term "abnormal income" means income of any class described in paragraph (2) includible in the gross income of the taxpayer for any taxable year under this subchapter if it is abnormal for the taxpayer to derive income of such class, or, if the taxpayer normally derives income of such class but the amount of such income of such class includible in the gross income of the taxable year is in excess of 115 per centum of the average amount of the gross income of the same class for the four previous taxable years, or, if the taxpayer was not in existence for four previous taxable years, the taxable years during which the taxpayer was in existence.

(2) *Separate classes of income.*—Each of the following subparagraphs shall be held to describe a separate class of income:

(A) Income arising out of a claim, award, judgment, or decree, or interest on any of the foregoing; or

(B) Income resulting from exploration, discovery, or prospecting, or any combination of the foregoing, extending over a period of more than 12 months; or

(C) Income from the sale of patents, formulae, or processes, or any combination of the foregoing, developed over a period of more than 12 months; or

(D) Income includible in gross income for the taxable year rather than for a different taxable year by reason of a change in the taxpayer's method of accounting.

All the income which is classifiable in more than one of such subparagraphs shall be classified under the one which the taxpayer irrevocably elects. The classification of income of any class not described in subparagraphs (A) to (D), inclusive, shall be subject to regulations prescribed by the Secretary.

(3) *Net abnormal income.*—The term "net abnormal income" means the amount of the abnormal income less, under regulations prescribed by the Secretary, (A) 115 per centum of the average amount of the gross income of the same class determined under paragraph (1), and (B) an amount which bears the same ratio to the amount of any costs or deductions relating to such abnormal income, allowable in determining the normal-tax net income for the taxable year, as the excess of the amount of such abnormal income over 115 per centum of such average amount bears to the amount of such abnormal income.

(b) *Amount Attributable to Other Years.*—The amount of the net abnormal income that is attributable to any previous or future tax-

579949—61——8

able year or years shall be determined under regulations prescribed by the Secretary. In the case of amounts otherwise attributable to future taxable years, if the taxpayer either transfers substantially all its properties or distributes any property in complete liquidation, then there shall be attributable to the first taxable year in which such transfer or distribution occurs (or if such year is previous to the taxable year in which the abnormal income is includible in gross income to such latter taxable year) all amounts so attributable to future taxable years not included in the gross income for a previous taxable year.

(c) *Computation of Tax for Current Taxable Year.*—The tax under this subchapter for the taxable year, in which the whole of such abnormal income would without regard to this section be includible, shall not exceed the sum of:

(1) The tax under this subchapter for such taxable year computed without the inclusion in gross income of the portion of the net abnormal income which is attributable to any other taxable year, and

(2) The aggregate of the increase in the tax under this subchapter for the taxable year (computed under paragraph (1)) and for each previous taxable year which would have resulted if, for each previous taxable year to which any portion of such net abnormal income is attributable, an amount equal to such portion had been included in the gross income for such previous taxable year.

(d) *Computation of Tax for Future Taxable Year.*—The amount of the net abnormal income attributable to any future taxable year shall, for the purposes of this subchapter, be included in the gross income for such taxable year.

(1) The tax under this subchapter for such future taxable year shall not exceed the sum of—

(A) the tax under this subchapter for such future taxable year computed without the inclusion in gross income of the portion of such net abnormal income which is attributable to such year; and

(B) the decrease in the tax under this subchapter for the previous taxable year in which the whole of such abnormal income would, without regard to this section, be includible which resulted by reason of the computation of such tax for such previous taxable year under the provisions of subsection (c); but the amount of such decrease shall be diminished by the aggregate of the increases in the tax under this subchapter for the future taxable year as computed under subparagraph (A) and for the taxable years intervening between such previous taxable year and such future taxable year which have resulted because of the inclusion of the portions of such net abnormal income attributable to such intervening years in the gross income for such intervening years.

(2) If, in the application of subsection (c), net abnormal income from more than one taxable year is attributable to any future taxable year, paragraph (1) of this subsection shall be applied with respect to such future taxable year in the order of the taxable years from which the net abnormal income is attributable beginning with the earliest, as if the portion of the net abnormal income from each such year was the only amount so attributable to such future taxable year, and (except in the case of the portion for the earliest previous taxable year) as if the tax under this subchapter for the future taxable year was the tax determined under paragraph (1) with respect to the portion for the next earlier previous taxable year.

(3) If in the application of paragraph (1) to any future taxable year it is determined that the decrease in tax computed under paragraph (1)(B) with respect to the net abnormal income, a portion of which is included in the gross income for the future taxable year, does not exceed the aggregate of the increases in tax computed under paragraph (1)(B) with respect to such net abnormal income, then the portions of such net abnormal income attributable to taxable years subsequent to such future taxable year shall not be included in the gross income for such subsequent taxable year. For the purpose of computing the tax under this subchapter for a taxable year subsequent to the future taxable year, the portion of net abnormal income attributable to the future taxable year shall not be included in the gross income for such future taxable year to the extent that the inclusion of such portion of net abnormal income in the gross income for such future taxable year did not result in an increase in tax for such future taxable year by reason of the provisions of paragraph (1).

(e) *Application of Section.*—This section shall be applied only for the purpose of computing the tax under this subchapter as provided in subsections (c) and (d), and shall have no effect upon the computation of base period net income. For the purposes of subsections (c) and (d)—

(1) Net abnormal income means the aggregate of the net abnormal income of all classes for one taxable year.

(2) Under regulations prescribed by the Secretary, the tax under this subchapter for previous taxable years shall be computed as if the portions of net abnormal income for each previous taxable year for which the tax was computed under this section were included in the gross income for the other pre-

vious taxable years to which said portions were attributable.

(3) If both subsections (c) and (d) are applicable to any current taxable year, subsection (d) shall be applied without regard to subsection (c), and subsection (c) shall be applied as if the tax under this subchapter, except for subsection (c), was the tax computed under subsection (d) and as if the gross income and the other amounts necessary to determine the adjusted excess profits net income were those amounts which would result in the tax computed under subsection (d).

(26 U.S.C. 1952 ed., Sec. 456.)

* * * * *

CHAPTER 2—ADDITIONAL INCOME TAXES

* * * * *

SUBCHAPTER E—EXCESS PROFITS TAX

[As added by Sec. 201, Second Revenue Act of 1940, c. 757, 54 Stat. 974.]

SEC. 710. IMPOSITION OF TAX.

(a) [as amended by Sec. 201(a), Revenue Act of 1941, c. 412, 55 Stat. 687; and Sec. 202, Revenue Act of 1942, c. 619, 56 Stat. 798]. *Imposition.*—

(1) *General Rule.*—There shall be levied, collected, and paid, for each taxable year, upon the adjusted excess-profits net income, as defined in subsection (b), of every corporation (except a corporation exempt under section 727) a tax equal to whichever of the following amounts is the lesser:

* * * * *

(b) [as amended by Sec. 2(a), Excess Profits Tax Amendments of 1941, c. 10, 55 Stat. 17; and Sec. 204(a), Revenue Act of 1942, *supra*]. *Definition of Adjusted Excess Profits Net Income.*—As used in this section, the term "adjusted excess profits net income" in the case

of any taxable year means the excess profits net income (as defined in section 711) minus the sum of:

(1) *Specific exemption.*—A specific exemption of $5,000;

(2) *Excess profits credit.*—The amount of the excess profits credit allowed under section 712; and

(3) *Unused excess profits credit.*—The amount of the unused excess profits credit adjustment for the taxable year, computed in accordance with subsection (c).

* * * * *

(26 U.S.C. 1952 ed., Sec. 710.)

SEC. 711. EXCESS PROFITS NET INCOME.

(a) *Taxable Years Beginning After December 31, 1939.*—The excess profits net income for any taxable year beginning after December 31, 1939, shall be the normal-tax net income, as defined in section 13(a)(2), for such year except that the following adjustments shall be made:

(1) *Excess profits credit computed under income credit.*—If the excess profits credit is computed under section 713, the adjustments shall be as follows:

* * * * *

(I) [as added by Sec. 209(a) of the Revenue Act of 1942, *supra*, and as amended by Sec. 208(d) of the Revenue Act of 1943, c. 63, 58 Stat. 21] *Nontaxable income of certain industries with depletable resources.*—In the case of a producer of minerals, or a producer of logs or lumber from a timber block, or a lessor of mineral property, or a timber block, as defined in section 735, there shall be excluded nontaxable income from exempt excess output of mines and timber blocks provided in section 735; in the case of a natural gas company, as defined in section 735, there shall be excluded nontaxable income from exempt excess

output provided in section 735; and in the case of a producer of minerals or a producer of logs or lumber from a timber block, there shall be excluded nontaxable bonus income provided in section 735. In respect of nontaxable bonus income provided in section 735(c), a corporation described in section 735(c)(2) shall be deemed a producer of minerals for the purposes of this subparagraph.

* * * * *

(2) *Excess profits credit computed under invested capital credit.*—If the excess profits credit is computed under section 714, the adjustments shall be as follows:

* * * * *

(b) [as amended by Sec. 3, Excess Profits Tax Amendments of 1941, *supra*]. *Taxable Years in Base Period.*—

(1) *General rule and adjustments.*—The excess profits net income for any taxable year subject to the Revenue Act of 1936 shall be the normal-tax net income, as defined in section 13(a) of such Act; and for any other taxable year beginning after December 31, 1937, and before January 1, 1940, shall be the special-class net income, as defined in section 14(a) of the applicable revenue law. In either case the following adjustments shall be made (for additional adjustments in case of certain reorganizations, see section 742(e)):

* * * * *

(H) *Payment of judgments, and so forth.*—Deductions attributable to any claim, award, judgment, or decree against the taxpayer, or interest on any of the foregoing, if abnormal for the taxpayer, shall not be allowed, and if normal for the taxpayer, but in excess of 125 per centum of the average amount of such deductions in

the four previous taxable years, shall be disallowed in an amount equal to such excess;

(I) *Intangible drilling and development costs.*—Deductions attributable to intangible drilling and development costs paid or incurred in or for the drilling of wells or the preparation of wells for the production of oil or gas, and for development costs in the case of mines, if abnormal for the taxpayer, shall not be allowed, and if normal for the taxpayer, but in excess of 125 per centum of the average amount of such deductions in the four previous taxable years, shall be disallowed in an amount equal to such excess; and

(J) *Abnormal deductions.*—Under regulations prescribed by the Commissioner, with the approval of the Secretary, for the determination, for the purposes of this subparagraph, of the classification of deductions—

(i) Deductions of any class shall not be allowed if deductions of such class were abnormal for the taxpayer, and

(ii) If the class of deductions was normal for the taxpayer, but the deductions of such class were in excess of 125 per centum of the average amount of deductions of such class for the four previous taxable years, they shall be disallowed in an amount equal to such excess.

(K) *Rules for application of subparagraphs (H), (I), and (J).*—For the purposes of subparagraphs (H), (I), and (J)—

* * * * *

(ii) Deductions shall not be disallowed under such subparagraphs unless the taxpayer establishes that the abnormality or

excess is not a consequence of an increase in the gross income of the taxpayer in its base period or a decrease in the amount of some other deduction in its base period, and is not a consequence of a change at any time in the type, manner of operation, size, or condition of the business engaged in by the taxpayer.

* * * * *

(26 U.S.C. 1956 ed., Sec. 711.)

SEC. 712 [as amended by Sec. 13, Excess Profits Tax Amendments of 1941, *supra*]. EXCESS PROFITS CREDIT—ALLOWANCE.

(a) *Domestic Corporations.*—In the case of a domestic corporation which was in existence before January 1, 1940, the excess profits credit for any taxable year shall be an amount computed under section 713 or section 714, whichever amount results in the lesser tax under this subchapter for the taxable year for which the tax under this subchapter is being computed. * * *

* * * * * *

(26 U.S.C. 1952 ed., Sec. 712.)

SEC. 713 [as amended by Sec. 4, Excess Profits Tax Amendments of 1941, *supra*, and Sec. 214(a), Sec. 215, and Sec. 228(e)(2), Revenue Act of 1942, *supra*]. EXCESS PROFITS CREDIT—BASED ON INCOME.

(a) *Amount of Excess Profits Credit.*—The excess profits credit for any taxable year, computed under this section, shall be—

(1) *Domestic corporations.*—In the case of a domestic corporation—

(A) 95 per centum of the average base period net income,

(B) Plus 8 per centum of the net capital addition as defined in subsection (g), or

(C) Minus 6 per centum of the net capital reduction as defined in subsection (g).

* * * * *

(b) *Base Period.*—

(1) *Definition.*—As used in this section the term "base period"—

(A) If the corporation was in existence during the whole of the forty-eight months preceding the beginning of its first taxable year under this subchapter, means the period commencing with the beginning of its first taxable year beginning after December 31, 1935, and ending with the close of its last taxable year beginning before January 1, 1940; and

* * * * *

(2) *Division into halves.*—For the purposes of subsections (d) and (f) the base period of the taxpayer shall be divided into halves, the first half to be composed of one-half the entire number of months in the base period and to begin with the beginning of the base period.

* * * * *

(d) *Average Base Period Net Income—Determination.*—

(1) *Definition.*—For the purposes of this section the average base period net income of the taxpayer shall be the amount determined under subsection (e), subject to the exception that if the aggregate excess profits net income for the last half of its base period, reduced by the aggregate of the deficits in excess profits net income for such half, is greater than such aggregate so reduced for the first half, then the average base period net income shall be the amount determined under subsection (f), if greater than the amount determined under subsection (e).

(2) For the purposes of subsections (e) and (f), if the taxpayer was in existence dur-

ing only part of the 48 months preceding the beginning of its first taxable year under this subchapter, its excess profits net income—

* * * * *

(3) In no case shall the average base period net income be less than zero.

* * * * *

(e) *Average Base Period Net Income—General Average.*—The average base period net income determined under this subsection shall be determined as follows:

(1) By computing the aggregate of the excess profits net income for each of the taxable years of the taxpayer in the base period, reduced by the sum of the deficits in excess profits net income for each of such years. If the excess profits net income (or deficit in excess profits net income) for one taxable year in the base period divided by the number of months in such taxable year is less than 75 per centum of the aggregate of the excess profits net income (reduced by deficits in excess profits net income) for the other taxable years in the taxpayer's base period divided by the number of months in such other taxable years (herein called "average monthly amount") the amount used for such one year under this paragraph shall be 75 per centum of the average monthly amount multiplied by the number of months in such one year, and the year increased under this sentence shall be the year the increase in which will produce the highest average base period net income;

(2) By dividing the amount ascertained under paragraph (1) by the total number of months in all such taxable years; and

(3) By multiplying the amount ascertained under paragraph (2) by twelve.

(f) *Average Base Period Net Income—Increased Earnings in Last Half of Base Period.*—The average base period net income

determined under this subsection shall be determined as follows:

(1) By computing, for each of the taxable years of the taxpayer in its base period, the excess profits net income for such year, or the deficit in excess profits net income for such year;

(2) By computing for each half of the base period the aggregate of the excess profits net income for each of the taxable years in such half, reduced, if for one or more of such years there was a deficit in excess profits net income, by the sum of such deficits. For the purposes of such computation, if any taxable year is partly within each half of the base period there shall be allocated to the first half an amount of the excess profits net income or deficit in excess profits net income, as the case may be, for such taxable year, which bears the same ratio thereto as the number of months falling within such half bears to the entire number of months in such taxable year; and the remainder shall be allocated to the second half;

(3) If the amount ascertained under paragraph 2 for the second half is greater than the amount ascertained for the first half, by dividing the difference by two;

(4) By adding the amount ascertained under paragraph (3) to the amount ascertained under paragraph (2) for the second half of the base period;

(5) By dividing the amount found under paragraph (4) by the number of months in the second half of the base period and by multiplying the result by twelve;

(6) The amount ascertained under paragraph (5) shall be the average base period net income determined under this subsection, except that the average base period net income determined under this subsection shall in no case be greater than the highest excess

profits net income for any taxable year in the base period. * * *

* * * * *

(26 U.S.C. 1952 ed., Sec. 713.)

SEC. 721 [as amended by Sec. 5, Excess Profits Tax Amendments of 1941, *supra*, and Sec. 221(a), Revenue Act of 1942, *supra*]. ABNORMALITIES IN INCOME IN TAXABLE PERIOD.

(a) *Definitions.*—For the purposes of this section—

(1) *Abnormal income.*—The term "abnormal income" means income of any class includible in the gross income of the taxpayer for any taxable year under this subchapter if it is abnormal for the taxpayer to derive income of such class, or, if the taxpayer normally derives income of such class but the amount of such income of such class includible in the gross income of the taxable year is in excess of 125 per centum of the average amount of the gross income of the same class for the four previous taxable years, or, if the taxpayer was not in existence for four previous taxable years, the taxable years during which the taxpayer was in existence.

(2) *Separate classes of income.*—Each of the following subparagraphs shall be held to describe a separate class of income:

(A) Income arising out of a claim, award, judgment, or decree, or interest on any of the foregoing; or

(B) Income constituting an amount payable under a contract the performance of which required more than 12 months;[1] or

[1] Subparagraph (B) of Section 721(a)(2) was made inapplicable to taxable years beginning after December 31, 1941, by Section 222(f) of the Revenue Act of 1942, which Act, by Section 222(d), added Section 736 to the Code to provide relief for taxpayers with income from long-term contracts.

(C) Income resulting from exploration, discovery, prospecting, research, or development of tangible property, patents, formulae, or processes, or any combination of the foregoing, extending over a period of more than 12 months; or

(D) Income includible in gross income for the taxable year rather than for a different taxable year by reason of a change in the taxpayer's accounting period or method of accounting; or

(E) In the case of a lessor of real property, income included in gross income for the taxable year by reason of the termination of the lease; or

(F) Income consisting of dividends on stock of foreign corporations, except foreign personal holding companies.

All the income which is classifiable in more than one of such subparagraphs shall be classified under the one which the taxpayer irrevocably elects. The classification of income of any class not described in subparagraphs (A) to (F), inclusive, shall be subject to regulations prescribed by the Commissioner with the approval of the Secretary.

(3) *Net abnormal income.*—The term "net abnormal income" means the amount of the abnormal income less, under regulations prescribed by the Commissioner with the approval of the Secretary, (A) 125 per centum of the average amount of the gross income of the same class determined under paragraph (1), and (B) an amount which bears the same ratio to the amount of any direct costs or expenses, deductible in determining the normal-tax net income of the taxable year, through the expenditure of which such abnormal income was in whole or in part derived as the excess of the amount of such abnormal income over 125 per centum of such

average amount bears to the amount of such abnormal income.

(b) *Amount Attributable to Other Years.*—The amount of the net abnormal income that is attributable to any previous or future taxable year or years shall be determined under regulations prescribed by the Commissioner with the approval of the Secretary. * * *

(c) *Computation of Tax for Current Taxable Year.*—The tax under this subchapter for the taxable year, in which the whole of such abnormal income would without regard to this section be includible, shall not exceed the sum of:

(1) The tax under this subchapter for such taxable year computed without the inclusion in gross income of the portion of the net abnormal income which is attributable to any other taxable year, and

(2) The aggregate of the increase in the tax under this subchapter for the taxable year (computed under paragraph (1) and for each previous taxable year which would have resulted if, for each previous taxable year to which any portion of such net abnormal income is attributable, an amount equal to such portion had been included in the gross income for such previous taxable year.

(d) *Computation of Tax for Future Taxable Year.*—* * *

* * * * *

(e) *Application of Section.*—This section shall be applied only for the purpose of computing the tax under this subchapter as provided in subsections (c) and (d), and shall have no effect upon the computation of base period net income. For the purposes of subsections (c) and (d)—

(1) Net abnormal income means the aggregate of the net abnormal income of all classes for one taxable year.

(2) Under regulations prescribed by the Commissioner with the approval of the Secretary, the tax under this subchapter for previous taxable years shall be computed as if the portions of net abnormal income for each previous taxable year for which the tax was computed under this section were included in the gross income for the other previous taxable years to which such portions were attributable.

(3) If both subsections (c) and (d) are applicable to any current taxable year, subsection (d) shall be applied without regard to subsection (c), and subsection (c) shall be applied as if the tax under this subchapter, except for subsection (c), was the tax computed under subsection (d) and as if the gross income and the other amounts necessary to determine the adjusted excess profits net income were those amounts which would result in the tax computed under subsection (d).

(f) *Abnormal Income From Exploration, Etc.*—If, by reason of taking into account, in determining constructive average base period net income under section 722, exploration, discovery, prospecting, research, or development of tangible property, patents, formulae, or processes, or any combination of the foregoing, extending over a period of more than 12 months, such constructive average base period net income is higher than it would be without such taking into account, only such portion of the income in the taxable year resulting from such activity which is of a class described in subsection (a)(2)(C) as is attributable to another taxable year under this subchapter shall be deemed attributable to a year other than the taxable year.

(26 U.S.C. 1952 ed., Sec. 721.)

SEC. 722 [as amended by Sec. 222(a), Revenue Act of 1942, *supra*, and Sec. 1, Act of December 17, 1943, c. 346, 57 Stat. 601]. GENERAL RELIEF — CONSTRUCTIVE AVERAGE BASE PERIOD NET INCOME

(a) *General Rule.*—In any case in which the taxpayer establishes that the tax computed under this subchapter (without the benefit of this section) results in an excessive and discriminatory tax and establishes what would be a fair and just amount representing normal earnings to be used as a constructive average base period net income for the purposes of an excess profits tax based upon a comparison of normal earnings and earnings during an excess profits tax period, the tax shall be determined by using such constructive average base period net income in lieu of the average base period net income otherwise determined under this subchapter. In determining such constructive average base period net income, no regard shall be had to events or conditions affecting the taxpayer, the industry of which it is a member, or taxpayers generally occurring or existing after December 31, 1939, except that, in the cases described in the last sentence of section 722(b)(4) and in section 722(c), regard shall be had to the change in the character of the business under section 722(b)(4) or the nature of the taxpayer and the character of its business under section 722(c) to the extent necessary to establish the normal earnings to be used as the constructive average base period net income.

(b) *Taxpayers Using Average Earnings Method.*—The tax computed under this subchapter (without the benefit of this section) shall be considered to be excessive and discriminatory in the case of a taxpayer entitled to use the excess profits credit based on income pursuant to section 713, if its average base period

net income is an inadequate standard of normal earnings because—

(1) in one or more taxable years in the base period normal production, output, or operation was interrupted or diminished because of the occurrence, either immediately prior to, or during the base period, of events unusual and peculiar in the experience of such taxpayer,

(2) the business of the taxpayer was depressed in the base period because of temporary economic circumstances unusual in the case of such taxpayer or because of the fact that an industry of which such taxpayer was a member was depressed by reason of temporary economic events unusual in the case of such industry,

(3) the business of the taxpayer was depressed in the base period by reason of conditions generally prevailing in an industry of which the taxpayer was a member, subjecting such taxpayer to

(A) a profits cycle differing materially in length and amplitude from the general business cycle, or

(B) sporadic and intermittent periods of high production and profits, and such periods are inadequately represented in the base period,

(4) the taxpayer, either during or immediately prior to the base period, commenced business or changed the character of the business and the average base period net income does not reflect the normal operation for the entire base period of the business. If the business of the taxpayer did not reach, by the end of the base period, the earning level which it would have reached if the taxpayer had commenced business or made the change in the character of the business two years before it did so, it shall be deemed to have commenced the business or made the change

at such earlier time. For the purposes of this subparagraph, the term "change in the character of the business" includes a change in the operation or management of the business, a difference in the products or services furnished, a difference in the capacity for production or operation, a difference in the ratio of nonborrowed capital to total capital, and the acquisition before January 1, 1940, of all or part of the assets of a competitor, with the result that the competition of such competitor was eliminated or diminished. Any change in the capacity for production or operation of the business consummated during any taxable year ending after December 31, 1939, as a result of a course of action to which the taxpayer was committed prior to January 1, 1940, or any acquisition before May 31, 1941, from a competitor engaged in the dissemination of information through the public press, of substantially all the assets of such competitor employed in such business with the result that competition between the taxpayer and the competitor existing before January 1, 1940, was eliminated, shall be deemed to be a change on December 31, 1939, in the character of the business, or

(5) of any other factor affecting the taxpayer's business which may reasonably be considered as resulting in an inadequate standard of normal earnings during the base period and the application of this section to the taxpayer would not be inconsistent with the principles underlying the provisions of this subsection, and with the conditions and limitations enumerated therein.

* * * * *

(d) *Application for Relief Under This Section.*—The taxpayer shall compute its tax, file its return, and pay the tax shown on its return under this subchapter without the application of this section, except as provided in section

710(a)(5). The benefits of this section shall not be allowed unless the taxpayer within the period of time prescribed by section 322 and subject to the limitation as to amount of credit or refund prescribed in such section makes application therefor in accordance with regulations prescribed by the Commissioner with the approval of the Secretary. If a constructive average base period net income has been determined under the provisions of this section for any taxable year, the Commissioner may, by regulations approved by the Secretary, prescribe the extent to which the limitations prescribed by this subsection may be waived for the purpose of determining the tax under this subchapter for a subsequent taxable year.

* * * * *

(f) *Mining Corporations.*—In the case of a taxpayer to which section 711(a)(1)(I) or section 711(a)(2)(K) applies, if its constructive average base period net income is established under this section, there shall also be determined a fair and just amount to be used as normal output and normal unit profit for the purposes of section 735.

(26 U.S.C. 1952 ed., Sec. 722.)

SEC. 732 [as added by Sec. 9, Excess Profits Tax Amendments of 1941, *supra;* and as amended by Sec. 222(c), Revenue Act of 1942, *supra;* Sec. 2, Joint Resolution of June 30, 1945, c. 211, 59 Stat. 295; and Sec. 203(a), Act of December 29, 1945, c. 652, 59 Stat. 669]. REVIEW OF ABNORMALITIES BY THE TAX COURT OF THE UNITED STATES.

(a) *Petition to the Tax Court.*—If a claim for refund of tax under this subchapter for any taxable year is disallowed in whole or in part by the Commissioner, and the disallowance relates to the application of section 711(b)(1)(H), (I), (J), or (K), section 721, or section

722, relating to abnormalities the Commissioner shall send notice of such disallowance to the taxpayer by registered mail. Within ninety days after such notice is mailed (not counting Saturday, Sunday, or a legal holiday in the District of Columbia as the ninetieth day) the taxpayer may file a petition with the Tax Court for a redetermination of the tax under this subchapter. If such petition is so filed, such notice of disallowance shall be deemed to be a notice of deficiency for all purposes relating to the assessment and collection of taxes or the refund or credit of overpayments.

(b) *Deficiency Found by the Tax Court in case of Claim.*—If the Tax Court finds that there is no overpayment of tax in respect of any taxable year in respect of which the Commissioner has disallowed, in whole or in part, a claim for refund described in subsection (a) and the Tax Court further finds that there is a deficiency for such year, the Tax Court shall have jurisdiction to determine the amount of such deficiency and such amount shall, when the decision of the Tax Court becomes final, be assessed and shall be paid upon notice and demand from the collector.

(c) *Finality of Determination.*—If in the determination of the tax liability under this subchapter the determination of any question is necessary solely by reason of section 711(b)(1) (H), (I), (J), or (K), section 721, or section 722, the determination of such question shall not be reviewed or redetermined by any court or agency except the Tax Court.

(d) *Review by Special Division of the Tax Court.*—The determinations and redeterminations by any division of the Tax Court involving any question arising under section 711(a)(2)(C) or section 722 with respect to any taxable year shall be reviewed by a special division of the Tax Court which shall be constituted by the presiding judge and consist of not less than

three judges of the Tax Court. The decisions of such special division shall not be reviewable by the Tax Court and shall be deemed decisions of the Tax Court.

(26 U.S.C. 1952 ed., Sec. 732.)

Treasury Regulations 130, relating to the Excess Profits Tax, promulgated (in 1951) under the Internal Revenue Code of 1939, as amended (for taxable years ending after June 30, 1950):

SEC. 40.456–2 [as amended by T.D. 6026, 1953–2 Cum. Bull. 235]. *Classification of Income.*—

(a) Section 456(a)(2) (A), (B), (C), and (D) sets forth four separate classes of income. All the income which reasonably is classifiable in more than one class shall be classified under the one which the taxpayer irrevocably elects. Such election shall be made in the manner prescribed in section 40.456–3. The classification of income for any year must be consistent with the classification made under section 456 for previous years. The classification must also be consistent with any classification made in applying section 433(b)(9) to the taxpayer.

(b) Other income, not within a class described in subparagraphs (A)–(D) of section 456(a)(2), to which section 456 is applicable may be grouped by the taxpayer, subject to approval by the Commissioner on the examination of the taxpayer's return, in such classes similar to those specified in subparagraphs (A)–(D) of section 456(a)(2) as are reasonable in a business of the type which the taxpayer conducts, and as are appropriate in the light of the taxpayer's business experience and accounting practice. Income from the sale of tangible property arising out of research and development which extended over a period of more than 12 months is not included in the list of abnormal types of income to which section 456 is applicable, and such income may not consti-

tute a class of income for purposes of that section. However, section 456 is applicable to such income if the income is otherwise properly includible within a class of income to which such section is applicable, for example, the class described in section 456(a)(2)(D)..

Rev. Rul. 236, 1953–2 Cum. Bull. 236:

1. *Purpose.*—The purpose of this Revenue Ruling is to state the position of the Internal Revenue Service with respect to the application of section 456 of the Internal Revenue Code (relating to the excess-profits tax) to taxpayers engaged in the extraction of petroleum and natural gas.

2. *Exploration, discovery, or prospecting.*—Exploration or prospecting by a taxpayer begins with the first field work designed to determine whether to acquire or retain the acreage in the area in which a discovery is later made. (See I.T. 4006, C.B. 1950–1, 38.) It does not include the general research of published reports to determine where exploration might be profitable. Exploration is ended and discovery occurs for a pool when a well is completed that proves the presence of oil or gas in commercial quantities. Subsequent drilling in the pool, while it may contain a large element of risk, constitutes exploitation to reap the benefits of the discovery. To the extent that "development" is the equivalent of "exploration" or "discovery," it may result in abnormal income under section 456; to the extent that "development" is the equivalent of "exploitation," it will not result in any abnormal income within the meaning of section 456.

3. *Period of exploration, discovery, or prospecting.*—To qualify under section 456(a)(2)(B) income must result from exploration, discovery, or prospecting, or any combination of the foregoing, extending over a period of more than 12 months. This means that the elapsed time between the commencement of exploration

or prospecting and the resulting discovery, as defined in paragraph 2, exclusive of any intervening periods of inactivity, must total more than 12 months. Only the actual time consumed from the initial steps in the exploration or prospecting to the final completion of the discovery well that proved the presence of oil or gas in commercial quantities is to be considered in measuring the time elapsed.

4. *Class of income.*—The entire income of a taxpayer which results from exploration, discovery, or prospecting, or any combination of the foregoing, extending over a period of more than 12 months, constitutes a single class of income.

5. *Determination of abnormal income.*—That part of the gross income from the sale of oil and/or gas from properties of the taxpayer which meets the other requirements of section 456 and which is attributable to the exploration, discovery, or prospecting of such properties constitutes abnormal income within the meaning of section 456(a)(2)(B). That part of the gross income from the sale of oil and/or gas from the taxpayer's properties which is attributable to the exploitation of such properties, however, does not under any circumstances constitute abnormal income within the meaning of section 456(a)(2)(B). Any method of allocation will be acceptable which reasonably determines the portions of income which are attributable to exploration, discovery, or prospecting of the properties and the portions of income which are attributable to the development or exploitation of the properties in view of the respective risks undertaken. For example, an amount equal to the total amount which would be realized over the life of the properties as overriding royalties if the properties had been subleased on the discovery date (or the actual amount so realized if the properties in fact were subleased) qualifies as

abnormal income. Such amount will not include any income which would be realized by the sublessee as the result of exploitation of such properties.

The amount which would be equal to the assumed overriding royalties (if the properties were not in fact subleased), or the income otherwise determined as attributable to exploration, discovery, or prospecting of the properties, must be established in the light of the conditions and circumstances known at the discovery date, regardless of later information concerning the properties. The terms of an assumed sublease shall be determined on the basis of a transfer between a willing sublessor and a willing sublessee as of the discovery date. Due weight shall be given to any and all facts and evidence having a bearing on the amount of such overriding royalties, or income attributable to exploration, discovery, or prospecting, such as the actual subleasing of similar properties, or the determination by an analytical method which will reasonably apportion the anticipated, undiscounted net earnings from such properties between the interest of the explorer, discoverer, or prospector, and the interest of a developer or exploiter. In the determination of net earnings, deductions from anticipated gross income shall include not only the estimated direct operating costs attributable to the production of oil and/or gas but also the estimated costs of drilling subsequent wells, general overhead, and any other deductions attributable to exploitation of the properties.

A method of determining abnormal income may be illustrated as follows: Assume that as of the date of discovery of a new pool, the estimated undiscounted net earnings from the taxpayer's properties are $1,250,000. Assume further that these properties could be subleased on a 40–60 basis (i.e. 40% of the estimated net

earnings attributed to the sublessor and 60% to the sublessee). These are all facts with respect to the properties to be determined by expert analysis such as by a petroleum engineer. Under these assumptions the sublessor's share of the total estimated net earnings is $500,000, and if the total estimated recoverable oil is 1,000,000 barrels, 50 cents of the income realized from each barrel of oil will be the income resulting from exploration, discovery, and prospecting (without regard to the ultimate amount of oil recovered from the property), and such 50 cents per barrel thus will represent abnormal income.

6. *Items of abnormal income.*—An item of abnormal income consists of the abnormal income, as defined above, attributable to a single discovery. Thus, the amount of an item of abnormal income in any taxable year is equal to that portion of the income, attributable to the discovery, realized in such taxable year from a particular oil and/or gas pool which is proved by a single discovery well. For the purposes of this Revenue Ruling, a "pool" means any underground accumulation of crude petroleum or associated hydrocarbon substances including, but not limited to, natural gas, constituting a single and separate reservoir or source of supply within a field. The probable limits of such new pool, as determined by the best evidence available at the date of completion of the discovery well, thus define the area within which all leases or properties owned at the time by the discoverer would be included in the discovery. Later discoveries of new pools in the same area may be made in different sands or horizons, and again the income attributable to the discovery of the new pool would be determined by the facts known as of the date of discovery. No adjustments will be made because of any subsequent information.

The abnormal income of a taxpayer for any year, either the current taxable year or one of the 4 prior taxable years, consists of the sum of the items of abnormal income, as defined above, from all discovery units of the taxpayer yielding such income in the given year.

7. *Net abnormal income attributable to other years.*—Net abnormal income, and items of net abnormal income, are to be determined as provided in Regulations 130, section 40.456–1. With respect, however, to the reduction for costs or deductions relating to the abnormal income called for by sections 40.456–1 (c)(3) and (d)(2), these costs and deductions other than the depletion allowable, are zero, since it is the expected *net* realization from anticipated production that is reflected in the sublessor's share of anticipated net earnings (50 cents per barrel of oil in the example given in paragraph 5) which is used to measure abnormal income. The amount of the depletion allowance relating to the abnormal income with respect to each item is an amount equal to the depletion deduction multiplied by the ratio of abnormal income to the net income before depletion. (The depletion allowance relating to the class of abnormal income is the sum of the depletion allowances relating to all of the items constituting the class.)

The amounts of net abnormal income attributable to other years are to be determined as provided in section 40.456–3. Any net abnormal income due to an increase in demand for oil or gas, as shown by appropriate sales or consumption data, is not attributable to other years, but to the current taxable year. Similarly, any net abnormal income due to increased prices is not attributable to other years; but if abnormal income has been determined by the method shown in the illustration in paragraph 5 above, or by any other method not involving fluctuating prices, then no net abnormal income

so determined will be attributable to the current taxable year by virtue of such increased prices.

Each item of net abnormal income attributable to other years is attributable to the years of exploration, discovery, or prospecting for such item in proportion to the ratio of expenditures for these activities in each such year to their total for all years.

* * * * *

U.S. GOVERNMENT PRINTING OFFICE: 1969